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COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

DEVELOPMENT OF THE LAW AND CONTINUING LEGAL ISSUES IN THE TAX TREATMENT OF PRIVATE FOUNDATIONS

JUNE 17, 1983

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PREFACE

This discussion document has been prepared at the request of the Subcommittee on Oversight of the Committee on Ways and Means. The conclusions and summaries presented are those of the authors and should not be construed to represent the position or views of the members of the Committee on Ways and Means.

LETTER OF REQUEST

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, D.C., May 3, 1983.

Hon. GILBERT GUDE,
Director, Congressional Research Service, the Library of Congress, Washington, D.C.

DEAR MR. GUDE: The Subcommittee on Oversight will hold hearings on June 27, 28, and 30, 1983, on Federal income tax rules applicable to private foundations. The purpose of the hearings is to receive information concerning whether the foundation rules, without imposing unnecessary or unduly burdensome restriction, ensure that only those private foundations operating for the public benefit enjoy favorable tax treatment. The press release announcing the hearings is attached.

It would greatly assist the Subcommittee if the American Law Division of the Congressional Research Service would prepare a report outlining the legislative history of the private foundation provisions of the Internal Revenue Code, with primary emphasis on those provisions enacted as part of the Tax Reform Act of 1969. A discussion of issues suggested by the history of the law and its operation would also be helpful.

Your assistance in this matter will be greatly appreciated.

Sincerely,

CHARLES B. RANGEL,
Chairman.

LETTER OF SUBMITTAL

CONGRESSIONAL RESEARCH SERVICE,
THE LIBRARY OF CONGRESS,
Washington, D.C., June 20, 1983.

Hon. CHARLES B. RANGEL,
Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: In response to your request, I am submitting a study entitled "Development of the Law and Continuing Legal Issues in the Tax Treatment of Private Foundations."

This study provides a historical summary of the history of the law governing the tax treatment of private foundations, emphasizing the developments leading to the adoption of the 1969 Tax Reform Act. It includes, as requested, a discussion of continuing issues involving the tax treatment of foundations in the context of the development of the law.

This study was prepared by Marie B. Morris and Thomas B. Ripy, Legislative Attorneys in the American Law Division.

We trust this report will be of assistance to the Subcommittee on Oversight and others in Congress concerned about tax treatment of private foundations.

Sincerely,

GILBERT GUDE,
Director.

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DEVELOPMENT OF THE LAW AND CONTINUING LEGAL ISSUES IN THE TAX TREATMENT OF PRIVATE FOUNDATIONS [1]

Executive Summary

A private foundation is a tax-exempt charitable organization founded by one or more persons and which receives most of its funds from its creators or a few substantial contributors. Private foundations usually finance their charitable activities with income earned on their investment assets. Because of their self-sustaining nature, private foundations do not usually need to look to the public for monetary support.

Prior to the Tax Reform Act of 1969, many private foundations were often closely tied to their founders or members of founders' families, and foundations often had substantial holdings in their founders' businesses. These relationships and the lack of public involvement in and information about their activities often made private foundations objects of suspicion.

Although in its early years the income tax law did not make distinctions between types of charities, there has been a trend in the last 40 years to gain more information about private foundations and to distinguish private foundations from public charities in several ways. The Revenue Act of 1943 was the first to require annual information returns from foundation-like organizations. The Revenue Act of 1950 was the first to place restrictions on their activities, requiring arm's-length dealings between foundations and substantial contributors. The Revenue Act of 1954 was the first to make distinctions in the charitable contribution deduction. Individual taxpayers were permitted to deduct charitable contributions up to 20 percent of adjusted gross income but allowed to deduct up to an additional 10 percent for contributions to specified charities, such as churches, schools, and others, which today are classified as public charities.

Present law retains the 20 percent limit for gifts to private grantmaking foundations generally, while providing a 50 percent limit for gifts to public charities and operating foundations. Additionally, while the taxpayer can deduct the fair market value of a gift of long term capital gain stock to public charities or operating foundations, his deduction is reduced if such a gift is made to a private foundation. A major reason for this distinction appears to be the belief that gifts to public charities and operating foundations are more rapidly utilized for public benefit, while those to foundations are often invested and, therefore, expenditures for actual charitable use are delayed for extended periods of time.

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[1] This paper has been prepared by Marie B. Morris and Thomas B. Ripy, legislative attorneys in the American Law Division of the Congressional Research Service, the Library of Congress.

The perception that foundations could be a potential vehicle for tax abuse was also a contributing factor in the distinctions made in the Tax Reform Act of 1969. For the first time, private foundations were defined by statute, and a series of prohibitions and limits on foundation structure and conduct were enforced by an excise tax mechanism. These limitations developed from investigations and studies, within and without Congress, involving alleged abuses of tax exempt organizations and private foundations in particular. While there has been some liberalization of the limitations imposed in 1969, primarily at the behest of private foundations and their beneficiaries, the major limitations remain largely intact.

The concluding section of this report raises and discusses several issues suggested by the history of the law and its operation, including whether and to what extent the distinction for charitable contributions is justified in the context of the limitations imposed by the 1969 Act; whether and to what extent the provisions of the 1969 Act impose appropriate rules for the transactions, investments, and expenditures of private foundations; and whether certain of these limits should be modified in special circumstances or through grants of greater administrative discretion.

INTRODUCTION

A typical private foundation is a tax-exempt organization which was founded by one or more persons, which is endowed by its founders, and which operates with limited public support or involvement. Traditionally, private foundations do not themselves do "good works"; rather, they grant money to other organizations and people for worthy causes. All private foundations are governed by four groups of provisions in the Internal Revenue Code ["IRC"]:

Provisions restricting income tax deductions for charitable contributions found in IRC § 170;

Definitions and special rules about private foundation status in IRC §§ 507–509, and 4947;

A series of excise taxes on prohibited activities found in IRC §§ 4941–4946, plus an excise tax on net investment income found in IRC § 4940;

Reporting and disclosure requirements in IRC § 6033.

This report is a legislative history of the private foundation provisions of the Internal Revenue Code, with primary emphasis on those provisions enacted as part of the Tax Reform Act of 1969. Although private foundations are also governed by the same rules applicable to all charitable organizations (such as the general requirements for tax-exempt status in IRC § 501(c)(3), the tax on unrelated business taxable income in §§ 511–514, and certain of the charitable deduction rules in § 170), this report does not focus on those provisions.

LEGISLATIVE HISTORY OF THE PRIVATE FOUNDATION PROVISIONS IN THE INTERNAL REVENUE CODE

Developments Before 1969

Origin of Exemption and Deduction

Prior to the Tax Reform Act of 1969,[1] there was no statutory definition of "private foundation". Although Congress began to make distinctions among types of tax-exempt organizations prior to 1969, in the early years of the modern income tax all charitable organizations were treated alike.

When the modern corporate income tax was enacted in 1909, it contained an exemption for

> Any corporation or association organized and operated exclusively for religious, charitable, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual.[2]

With several additions and minor amendments that language has formed the backbone of the provisions exempting charitable organizations from income tax since 1909. The equivalent provision under current law is found in IRC § 501(c)(3), to which both public charities and private foundations look for their exemption from income taxes today. In this paper, the term "charitable organization" refers to any organization described in IRC § 501(c)(3).

Another tax provision of overriding importance to both public charities and private foundations is the charitable contribution deduction, which generally allows donors to deduct from taxable income the value of money and property given to charitable organizations. The charitable contribution deduction from income tax became law in 1917.[3] The rules governing that deduction are currently in IRC § 170. The related charitable contribution deductions for estate and gift taxes were enacted in 1919 and 1924, respectively.[4] These provisions can now be found in IRC §§ 2055 and 2522.

Annual Report Requirement

Except for a provision of the Revenue Act of 1934 prohibiting charitable organizations from carrying on propaganda or lobbying,[5] Congress did not give serious legislative attention to charitable organizations until the Revenue Act of 1943. Until the adoption of

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[1] Although historians have traced the history of foundations back to the pharoahs of Egypt in 1400 B.C., this paper will take a more limited view and focus on the twentieth century U.S. tax history of private foundations. See Hollis, Evolution of the Philanthropic Foundation, Educational Record (October, 1939) as reprinted in Tax Exempt Foundations: Hearings on H. Res. 561. Before the Select Committee to Investigate Tax-Exempt Foundations and Comparable Organizations, 82d Cong., 2d Sess. 8–12 (1952).

[2] Act of Aug. 5, 1909, ch. 6, § 38 [1st], 36 Stat. 11.

[3] Revenue Act of 1917, ch. 63, § 1201(2), 40 Stat. 300.

[4] Revenue Act of 1918, Act of Feb. 24, 1919, ch. 18, § 403(a)(3), 40 Stat. 1057 [the provision was retroactive for all of 1918]; Revenue Act of 1924, Act of June 2, 1924, ch. 234, § 321(a)(2), 43 Stat. 253.

[5] Revenue Act of 1934, ch. 277, § 101(6), 23(o)(2), 48 Stat. 680, 690, 700.

that Act, exempt organizations were not even required to file annual returns. The 1943 Act required some organizations to list their gross incomes, receipts, and disbursements in an effort to collect information on whether certain business activities ought to be taxed; however, religious organizations, schools, certain fraternal organizations, publicly supported charitable organizations, and certain Government corporations were excepted from this requirement.[6] There was no explanation in the Committee reports as to why these distinctions among types of exempt organizations were made.

Unrelated Business Activities

During the early years of the income tax, there was some question about whether a charitable organization was permitted to carry on a commercial business and whether such a business would be subject to income taxes. In 1924, the Supreme Court's decision in *Trinidad* v. *Sagrada Orden*, 263 U.S. 578, seemed to indicate that a charitable organization could conduct a business which would be exempt from taxes as long as all the income from the business was devoted to charitable purposes.

This case gave birth to the so-called "destination of income" test. For some courts and some taxpayers, the destination of income test became a more important issue than the statutory language which required that the association or corporation be "organized and operated exclusively" for charitable purposes. In the next few decades, taxpayers and charitable organizations attempted to carry the destination of income test to its logical limits.

In 1947 hearings, the Committee on Ways and Means heard testimony that gave examples of abuses of the destination of income test. In 1946 Ramsey Accessories Corp. was sold to the tax-exempt Ramsey Corp., which channeled its profits to the medical and law schools affiliated with New York University. In 1947, supporters of New York University bought C. F. Mueller Co., one of the nation's largest producers of spaghetti products. Mueller Co. was converted to a nonprofit organization for the benefit of the law school of New York University. The Wisconsin Alumni Research Foundation was formed to hold a patent and make investments for the benefit of the University of Wisconsin.[7] The profits of these on-going businesses were not subject to tax.

There was also testimony that another example of tax avoidance was the sale of real estate to an exempt organization. The business would then lease the property from the organization. This removed the property from the tax rolls and created a deduction for lease payments which the business would not have received if it continued to own the property. Spiegel, Inc., Allied Stores Corp., Gimbel Bros., and Lit Bros. were mentioned as retailers who had taken advantage of this provision.[8]

In 1950, Treasury's Tax Legislative Counsel, Vance Kirby, testified that court decisions had rejected arguments that educational

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[6] Revenue Act of 1943, Act of Feb. 25, 1944, ch. 63, § 117(a), 58 Stat. 36. (The provision was effective for tax years beginning in 1943.)

[7] Revenue Revision 1947–1948: Hearings before the House Ways & Means Committee on Proposed Revisions of the Internal Revenue Code, 80th Cong., 1st Sess., pt. 5, 3411, 3463 (1947).

[8] Id. at 3411.

organizations which engaged in business operations which had no relation to their exempt purposes were not entitled to tax exemption. Treasury reported that exempt organizations engaged in the manufacture of automobile accessories, ceramics, food products, leather goods, and china ware. Treasury recommended that the unrelated business activities of charitable and educational organizations be subject to tax at the ordinary corporate rates. Under the proposal, business activities conducted by an exempt organization would not cause it to lose its exemption, but the business income would be segregated and subjected to income taxes. He proposed reaching the abuses in the lease-back situation by subjecting to tax a portion of the rental income generated by property acquired under a long-term lease-back arrangement. He also proposed that certain privately controlled trusts be required to expend substantially all their net income within a fixed period after the end of the tax year.[9]

In the 1950 hearings, the Committee on Ways and Means reviewed the Report of a Subcommittee of the Senate Committee on Interstate and Foreign Commerce, 81st Cong., 1st Sess., on the Investigation of Closing of Nashua, N.H., Mills and Operations of Textron Incorporated, which was reprinted in the 1950 hearings.[10] This report detailed how Royal Little and his company, Textron, Inc., used charitable trusts as a means of providing risk capital to Textron. According to the report, Textron gained an unfair competitive advantage and only an "infinitesimal portion" of the many millions of dollars received by the trusts were paid to the beneficiaries of the trusts.

Revenue Act of 1950

In the Revenue Act of 1950 Congress expressed its concern that businesses which channeled their profits to exempt organizations were not carrying out any exempt purpose and that they were gaining an unfair competitive advantage over taxable businesses by enacting the "feeder organization" rules and the "unrelated business income tax" rules. The feeder organization rules overturned the "destination of income" test and denied tax-exemption to businesses which channeled their profits to exempt organizations. The unrelated business income tax imposed corporate income taxes on the unrelated business income of exempt organizations, except churches, in excess of $1,000 a year. Exempt organizations conducting a trade or business were to be taxed like regular corporations.[11]

Also in the Revenue Act of 1950, the House had attempted to absolutely prohibit any self-dealing transactions between certain exempt organizations and substantial contributors or their relatives. The House also proposed a tax on accumulated investment income not paid out two-and-a-half months after the end of the tax year. The Senate Finance Committee viewed these provisions as too harsh and modified the prohibited transactions rules to require arm's-length dealing, and substituted a requirement for reporting

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[9] Revenue Revision of 1950: Hearings before the House Ways & Means Committee, 81st Cong., 2d Sess., pt. 1, 165–167 (1950).

[10] Id. at 510–530.

[11] Revenue Act of 1950, ch. 994, §§ 301(a) and (b), 64 Stat. 906, 948, 953, adding 1939 IRC §§ 54(f) and 421–423.

of accumulations in the annual report. The Conference Committee essentially adopted the Senate proposals, adding a denial of exemption for unreasonable accumulations.[12]

As finally adopted, certain organizations could lose their exemptions for engaging in specified self-dealing activities with substantial contributors or other related persons; for unreasonable accumulation of income; for using their income for non-exempt purposes; or for investing their income in a manner which would jeopardize the exempt purposes of the organization.[13]

As with the annual reporting requirements, imposed in the Revenue Act of 1943, certain organizations were excepted from the coverage of the prohibited transactions and unreasonable accumulation of income rules. Religious organizations, schools, publicly supported organizations, government-supported organizations, and medical organizations (including hospitals) did not have to comply with those rules.

Internal Revenue Code of 1954

From the time the 1917 provision permitting a tax deduction for gifts to a charitable organization was enacted until 1952, the deductible amount of income a taxpayer could donate to charity was limited to 15 percent of adjusted gross income. In 1952 this limit was raised to 20 percent of adjusted gross income in order to encourage gifts to colleges, hospitals, and other organizations dependent on private contributors to enable them to balance their budgets.[14]

With the adoption of the Internal Revenue Code of 1954, two substantive changes were made. One raised the limit on allowable charitable contribution deductions from 20 to 30 percent of adjusted gross income, providing that the extra 10 percent was made to one of three types of organizations: religious, educational or certain hospital organizations.[15] These roughly correspond to today's public charities. (Present law contains two additional categories of publicly supported organizations.)

The rationale for this increase for these three categories of organizations was explained in the Report of the Committee on Ways and Means as being "designed to aid these institutions in obtaining the additional funds they need, in view of their rising costs and the relatively low rate of return they are receiving on their endowment funds."[16] No explanation was made as to why the other organizations were not experiencing the same difficulties.

The second change made in 1954 was a restriction on participation in political campaigns for 501(c)(3) organizations. This amendment was introduced on the Senate floor by Lyndon Johnson. The reason for the addition was not explained.[17]

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[12] H. Rep't. No. 2319, 81st Cong., 2d Sess. 40-42 (1950), S. Rep't No. 2375, 81st Cong., 2d Sess. 34-37 (1950).
[13] Revenue Act of 1950, ch. 994, § 331, 64 Stat. 906, 957, adding 1939 IRC § 3814.
[14] Act of July 8, 1952, ch. 588, sec 4(a), 66 Stat. 442; S. Rep't. No. 1584, 82d Cong., 2d Sess. 2. (1952).
[15] Ch. 736, 170(b)(1), 68A Stat. 58.
[16] H. Rep't. No. 1337, 83d Cong., 2d Sess. 25 (1954).
[17] 100 Cong. Rec. 9604 (1954).

The Revenue Act of 1964

The Revenue Act of 1964 extended the 30 percent maximum charitable contribution deduction to most charitable organizations which were not private foundations. This was done in the interest of uniform treatment of the charitable organizations which were not eligible for the 30-percent deduction. The report of the Committee on Ways and Means stated it recognized the many beneficial activities that are carried on by various philanthropic organizations which were not eligible for the 30-percent deduction. The Committee limited the additional 10-percent deduction to organizations which were publicly or governmentally supported, and did not make it available to private foundations. The report stated that private foundations frequently did not make contributions to operating philanthropic organizations for extended periods of time and in the meanwhile used the funds for investment. The extra 10-percent deduction was intended to encourage immediately spendable receipts of contributions for charitable organizations.[18]

Congressional Investigations

In the years between 1950 and 1969, there were three major congressional investigations of private foundations. Interestingly, none of these were conducted by the tax-writing committees. The first two were born of the searches for Communists and Communist-influenced organizations in the early 1950s. The third was a 10-year investigation conducted by Representative Wright Patman and the Select Committee on Small Business, Subcommittee on Foundations.

Cox Committee

On April 4, 1952 the House created a Select Committee to Investigate Tax-Exempt Foundations and Comparable Organizations to determine which foundations were using their resources for nonexempt purposes, especially "un-American" or "subversive" activities.[19] The Select Committee, chaired by Representative E. E. Cox of Georgia and known as the "Cox Committee," held hearings in November and December [20] and made its report on January 1, 1953.[21] The Cox Committee endorsed the "great and significant services" of foundations, concluding that foundations seemed "to be a vital and essential factor in our progress."[22]

In reviewing the criticisms of foundations, the Cox Committee reported that there was little support for the allegation that foundation funds were being diverted from their intended use, but recommended public accounting to eliminate possible abuses. On the question of infiltration by subversives and support for the Communist system, the Cox Committee found that foundations were vulnerable but, for the most part, not deliberate supporters of Marxist philosophies.

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[18] H. Rep't. No. 749, 88th Cong., 1st Sess. (1963); P.L. 88-272, § 209, 78 Stat. 43.
[19] H. Res. 561, 82d Cong., 2d Sess., 98 Cong. Rec. 3489 (1952).
[20] Tax-Exempt Foundations: Hearings before the House Select Committee to Investigate Tax-Exempt Foundations and Comparable Organizations, 82d Cong., 2d Sess. (1952).
[21] H. Rep't. No. 2514, 82d Cong., 2d Sess. (1953).
[22] Id. at 6-7.

The Committee recommended that the names of contributors and amounts of contributions over $200 ought to be disclosed to the Bureau of Internal Revenue and that the foundations ought to publicly disclose all grants.

Chairman Cox died before the Select Committee issued its report. Representative B. Carroll Reece of Tennessee appended a note to the report emphasizing the short deadline under which the committee had operated and suggesting that a more thorough study be undertaken by the following Congress.

Reece Committee

In 1953, the House authorized the creation of the Special Committee to Investigate Tax-Exempt Foundations and Comparable Organizations to determine if any foundations and organizations were using their resources for non-exempt purposes, subversive activities, political purposes, propaganda, or to influence legislation. This committee, chaired by Congressman Reece, conducted hearings in 1954 and presented its report on December 16, 1954.[23]

The majority of the committee focused on criticisms of foundations,[24] and the tone of the majority report was quite antagonistic. The majority found that the number of foundations was increasing rapidly and the motivation for the increase was tax-planning rather than charity. The majority believed that the Internal Revenue Service was not staffed adequately to scrutinize the propriety and legality of the work of foundations. The majority emphasized that the public should be made aware of the impact of foundations on national affairs.

In spite of this apparent hostility to foundations, the committee report rejected the idea of abolishing foundations, the idea of eliminating Federal tax exemption for foundations, and the idea of national incorporation of foundations. The Reece Committee did recommend continuing the investigation of foundations using background research rather than taking witnesses' statements. It was thought that balance sheets and lists of assets and other types of documentary evidence needed to be analyzed by professionals.

Several of the Reece Committee's recommendations presaged the developments in 1969. For example, the Reece Committee recommended that the Committee on Ways and Means define and distinguish private foundations from other tax-exempt charitable organizations; study the advisability of denying a tax exemption to foundations holding more than five or ten percent of their capital in securities of one enterprise; and consider giving foundations a limited period of two to five years to bring their holdings down to the prescribed level whenever they received a large holding. The Reece Committee also recommended that foundations be given a two or three year period to distribute each year's income, including capital gains. In addition, the Reece Committee report recommended that loss of a tax exemption should not be limited to the effective date of the revocation of the exemption. The thought was that a

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[23] Tax Exempt Foundations: Hearings before the House Special Committee to Investigate Tax-Exempt Foundations and Comparable Organizations, 83d Cong., 2d Sess., on H. Res. 217 (1954); H. Rep't. No. 2681, 83d Cong., 2d Sess. (1954).

[24] H. Rep't. No. 2681, 83d Cong., 2d Sess. 3 (1954).

non-exempt organization should not be able to control a fund of assets which it had accumulated as an exempt organization. It was thought that the threat of retroactive revocation of the exemption to the extent of the foundation's remaining assets would discourage subversive activities.

Patman Investigations

During May 1961, Representative Wright Patman placed four statements in the Congressional Record detailing the growth of foundations since 1939 in numbers, asset size, and influence; commenting on the lack of legal supervision of foundations; expressing his belief that because foundations were created with tax-deductible funds and operated under tax-exempt status, foundations and their money were public trusts; and describing the limitations under which the IRS operated and the need for clearer laws. Mr. Patman reminded the Members of the earlier congressional investigations of foundations and of the Reece Committee's recommendations that a research-backed investigation be done. Each of these statements suggested that Congress ought to investigate these matters.[25]

In August 1961, Mr. Patman announced on the floor that he had begun a study of foundations and that he would report his findings to the House of Representatives from time to time.[26] In September Representative Thomas B. Curtis accused Mr. Patman of acting improperly in conducting his own investigation and suggested that such an investigation ought to be referred to a committee. Mr. Curtis suggested that the Committee on Ways and Means was probably the proper forum, although he could see reasons for the investigation being referred to the Joint Economic Committee or the Select Committee on Small Business. Mr. Patman resisted Mr. Curtis' suggestions, indicating that he was merely in an information collecting stage and that at such time as he thought there ought to be an investigation he would refer it to a committee. He especially resisted the suggestion of referral to the Committee on Ways and Means, stating that this was a small business matter and involved the whole economy. He admitted that Ways and Means had jurisdiction but stated they had not touched the question at all for a number of years.[27]

To begin his investigation, Mr. Patman had sent inquiries to over 500 foundations asking for information on their activities. In January 1962 the Select Committee on Small Business, of which Mr. Patman was chairman, formed a new subcommittee on foundations and their impact on small business. Mr. Patman became chairman of the subcommittee, a position he retained even after he relinquished the chair of the full committee in order to become chairman of the Banking and Currency Committee. Over the next 10 years, Mr. Patman issued eight installments of his report on foundations. These reports emphasized the business involvement of tax-exempt foundations.

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[25] 107 Cong. Rec. 7016–17; 7250–51; 7433–34; 7555–7566 (1961).
[26] 107 Cong. Rec. 14789–797 (1961).
[27] 107 Cong. Rec. 18632–18642 (1961). Mr. Curtis was a member of the Committee on Ways and Means and the Joint Economic Committee. Mr. Patman was chairman of the Joint Economic Committee and the Select Committee on Small Business.

The first report, issued in December 1962, began with a call for an immediate moratorium on foundation tax exemptions for the following reasons:

1. Laxness and irresponsibility on the part of the Internal Revenue Service.
2. Violations of law and Treasury regulations by far too many of the foundations encompassed in our study.
3. The withdrawal of almost $7 billion from the reach of tax collectors for taxable years 1951 through 1960.
4. The rapidly increasing concentration of economic power in foundations.
5. Foundation-controlled enterprises possess the money and competitive advantages to eliminate the small businessman.[28]

Each of these allegations was expanded at length to justify future study of the problems in each area. The first installment concluded with 17 recommendations, including:

1. Limiting the life of foundations to 25 years;
2. Prohibiting foundations from engaging in business directly or indirectly;
3. Banning commercial money lending and borrowing;
4. Enforcing the arm's-length relationships rules;
5. Prohibiting foundations from soliciting or accepting contributions from suppliers;
6. Limiting foundations' ownership of stock to 3 percent of any corporation and prohibiting foundations from voting their stock;
7. Denying charitable contribution deductions to persons who control foundations until the money is actually used for charity;
8. Altering rules on the value of gifts given to foundations;
9. Treating contributions and capital gains as income not capital; and
10. Applying the corporate accumulated earnings tax to controlled foundations.[29]

The second installment of the Patman reports was issued in October 1963 and the third installment was published in March 1964.[30] These reports criticized the Treasury for "splendidly ineffective supervision" which allowed charitable foundations to be used for tax avoidance and control of business.[31] The reports studied four groups of foundations, detailing their activities and abuses of tax-exempt status: the Baird Foundations; the Jessie Smith Noyes Foundation; the Lawrence A. Wien Foundation and the Harry B. Helmsley Foundation; and the Alfred I. du Pont Estate and the Nemours Foundation.

In 1966, the fourth installment of the Patman reports summarized what 575 foundations did with their money—less than half of their receipts (48%) were distributed, roughly 10 percent went to administrative expenses.[32] The fifth installment contained over 1000 pages of detail on the James Irvine Foundation.[33] This brought the continuing contest between the foundation managers and the heirs of James Irvine over control of the Irvine Co. to the congressional arena.

The sixth installment studied the foundations of America's wealthiest families, criticized their expenditures (not enough, too-

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[28] Select Committee on Small Business (Chairman's Report), 87th Cong., 2d Sess., Tax-Exempt Foundations and Charitable Trusts: Their Impact on Our Economy 1 (Comm. Print 1962) [hereinafter Patman Report, 1st Installment].

[29] Patman Report, First Installment, at 133–134.

[30] Subcommittee Chairman's Report to Subcommittee No. 1, Select Committee on Small Business, 88th Cong., 1st Sess., Tax-Exempt Foundations and Charitable Trusts: Their Impact on Our Economy (Second Installment) (Comm. Print 1963) [subsequent Patman reports will be installment, congress, and date]; Patman Report, Third Installment, 88th Cong., 2d Sess. (Comm. Print 1964).

[31] Patman Report, Second Installment, at ix.

[32] Patman Report, Fourth Installment, 89th Cong., 2d Sess. 3 (1966).

[33] Pat man Report, Fifth Installment, 90th Cong., 1st Sess. (1967).

much overseas), criticized the use of foundations to escape estate taxes, to control businesses, to pay obligations to relatives, to pay annuities to themselves, and criticized the Treasury as a toothless watchdog.[34] The seventh installment was issued while the Congress was considering the Tax Reform Act of 1969. That installment consisted of Mr. Patman's testimony on the topic before the House Committee on Ways and Means.[35]

The eighth installment was a study of the 1968 annual reports of 20,166 private foundations. The study was an attempt to develop comprehensive financial data for all private foundations in order to gain statistical insights into the economic impact of foundations. It was believed that the information would be especially useful for comparative purposes in determining the effectiveness of the Tax Reform Act of 1969.[36]

1965 Treasury Report on Private Foundations

In 1965 the Treasury issued a report on private foundations in response to requests from the House Committee on Ways and Means and the Senate Finance Committee. For purposes of its report, Treasury defined a private foundation in a way which presaged the 1969 tax law definition. Private foundations were defined as all organizations granted tax exemption by IRC § 501(c)(3) with the exception of:

(a) Organizations which normally receive a substantial part of their support from the general public or governmental bodies;
(b) Churches or conventions or associations of churches;
(c) Educational organizations with regular faculties, curriculums, and student bodies; and
(d) Organizations whose purpose is testing for public safety; and nonexempt trusts empowered by their governing instruments to pay or permanently set aside amounts for certain charitable purposes.[37]

The problems identified by Treasury included: [38]

1. *Delay in benefit to charity.* The 1950 provision denying an exemption for unreasonable accumulations or substantial noncharitable use of income was difficult to apply and enforce because of its indefiniteness. Treasury recommended that private foundations should be required to devote all of their net income to active charitable operations on a reasonably current basis. Treasury objected to retention of income to increase the capital of the foundation. Treasury would have tempered this distribution requirement with a rule permitting accumulation for a specified reasonable period if the purpose was clearly identified in advance and accumulation would have been necessary. Treasury would have also permitted a five-year carryforward of excess contributions. For foundations with investments in low-yielding assets, Treasury recommended re-

[34] Patman Report, Sixth Installment, 90th Cong., 2d Sess. (1968).
[35] Patman Report, Seventh Installment, 91st Cong., 1st Sess. (1969).
[36] Staff Report for the Subcommittee on Domestic Finance, House Committee on Banking and Currency, 92d Cong., 2d Sess., Tax-Exempt Foundations and Charitable Trusts: Their Impact on Our Economy [Eighth Installment] (Comm. Print 1972). [The jurisdiction for the study was transferred from Subcommittee No. 1 of the House Select Small Business Committee to the Committee on Banking and Currency on April 27, 1971. Effective January 3, 1975 (H. Res. 988, 93d Cong.) jurisdiction over tax-exempt foundations and charitable trusts was transferred to the Committee on Ways and Means.]
[37] House Committee on Ways and Means, 89th Cong., 1st Sess. Treasury Department Report on Private Foundation iii, 1-2 (1965).
[38] Id. at 6-14

quiring a minimum distribution equal to the greater of the net income or a percentage of asset value.

2. *Foundation involvement in business.* Some foundations owned controlling interests in one or more businesses. Foundations operated businesses ranging from a large metropolitan newspaper to radio broadcasting stations, from lumber companies to clothing manufacturers, from department stores to hotels. A commercial business could capitalize a subsidiary only with after-tax dollars. However, if the company "donated" tax-deductible money to a foundation, the foundation could set up or buy the same subsidiary for about half the price after taxes to the controlling company. Foundations could lease business assets to taxable subsidiaries which would pay the foundation tax-deductible rent. Rent was and is not taxable to foundations. The foundation could accumulate this income tax-free and reinvest or loan the money in the business it controlled. Even the existence of the unrelated business income tax and the feeder organization rules did not stem the disadvantages for regular businesses, opportunities for self-dealing, and diversion of foundation management to business rather than charitable concerns. Treasury recommended prohibiting foundations from owning 20 percent or more of a business unrelated to the charitable activities of the foundation.

3. *Family use of foundations to control corporate and other property.* The Treasury was concerned that foundations could be used as convenient vehicles for maintaining control of a family corporation while diminishing the burden of income, gift, and estate taxes for the family. A donor could give the foundation sufficient stock in a corporation to generate a generous charitable contribution deduction and at the same time reduce the value of the equity in the corporation which the donor controlled. This would reduce any estate or gift taxes at the time the donor passed control to the next generation. Family control of the private foundation would assure that giving away shares in the corporation would not result in outsiders running the family business.

Family control was found to aggravate the other problems of private foundations such as self-dealing, conflict of interest, and delay in or absence of benefit to the charity. Treasury recommended disallowing charitable contribution deductions (either income or estate tax) for transfers of interests in family corporations until the foundation disposed of the contributed asset, the foundation devoted the asset to active charitable operations, or donor control over the business or asset terminated. Control would have been presumed to exist if the donor or related parties owned at least a 20 percent interest in the corporation.

4. *Financial transactions unrelated to charitable functions.* The Treasury recommended prohibiting all borrowing for investment purposes by private foundations; it recommended limiting foundation lending activities to necessary, safe and appropriate investments; and it proposed prohibiting foundations from trading and speculating in securities. Treasury was concerned that private parties were able to shift the benefits of a foundation's tax exemption to themselves by using a foundation as an intermediary.

5. *Self-dealing.* The arm's-length standards imposed by the Revenue Act of 1950 were so imprecise that the law was difficult and

expensive to administer. Foundation donors could call upon their foundations to make loans to themselves and their businesses. Donor-trustees could keep foundation funds liquid if they foresaw a need for a future loan, rather than taking advantage of the higher yields of less liquid investments. A donor could "donate" cash or property to a foundation and have the foundation lend the money or property to his business. Taking into account the tax deduction for the gift, a donor in the 50 percent bracket could make twice as much available to a business by funneling the cash through the foundation as he could by loaning after-tax cash straight to the business. However, at the time of repayment, the foundation not the donor would get the cash. Another technique was to donate property to a foundation to hold under an option to repurchase, thus keeping potential gain available to the donor. Treasury recommended a return to the total prohibitions against self-dealing contained in the original House bill.

6. *Broadening foundation management.* Treasury recommended limiting donor influence after 25 years of foundation existence. After that time the donor and related parties would not be permitted to constitute more than 25 percent of the governing body of the foundation. Treasury suggested a phase-in for existing foundations. The Department rejected the idea of limiting the life of foundations to a specified period, finding no excessive control of the economy by foundations.

Treasury's additional recommendations included denying charitable contribution deductions for gifts of unproductive property until the foundation sold the property, made it productive, or applied it to a charitable activity; offsetting the deduction for gifts of ordinary income property by the amount of gain which a donor would have realized if the property had been sold; changing the relationship of the estate tax marital deduction and the charitable contribution deduction, and imposing lesser sanctions for failing to file the annual information return when the offense was not criminal in nature.

The Tax Reform Act of 1969 (P.L. 91-172)

Section 110 of the Revenue and Expenditure Control Act of 1968 (P.L. 90-364) directed the President to submit to the Congress proposals for a comprehensive reform of the Internal Revenue Code of 1954 not later than December 31, 1968. By letter to the Speaker of the House of Representatives dated December 31, 1968, President Johnson advised the Congress of the existence of the studies and proposals for tax reform which were developed in the Treasury Department pursuant to the Revenue and Expenditure Control Act of 1968, and of his decision to make no recommendations to the Congress in light of the fact that he would be leaving office on January 20, 1969.[39]

The chairmen of the tax-writing committees requested that the Treasury studies and proposals be submitted to the Congress, and

[39] U.S. Treasury Department, Tax Reform Studies and Proposals, a joint publication of the House Committee on Ways and Means and the Senate Committee on Finance, 91st Cong., 1st Sess. iii (Comm. Print Feb. 5, 1969).

this was done by the new Nixon administration Treasury staff. The proposals were printed by both tax committees as a joint publication for information purposes.[42]

There was no specific bill before the Committee on Ways and Means when it began its hearings on tax reform in February 1969, and the Treasury proposals served as a basis for discussion in the hearings. Treasury's recommendations in two areas were to affect private foundations:

1. Treasury recommended changes in the charitable contribution deduction. One of these was that persons owning appreciated property not be able to realize a greater after-tax profit by donating the property to a charity than they would by selling the property, paying taxes on the gain, and keeping the proceeds.

2. Treasury recommended that the Congress act on the report on private foundations which Treasury had submitted to the Congress in 1965.

House Hearings

The Committee on Ways and Means held four days of hearings on private foundations with Wright Patman as the lead-off witness. His legislative proposals were the most stringent suggested by anyone: tax private foundations at 20% of their gross income, including capital gains; limit ownership of shares in a business to 3% of capital or profits; and require annual disbursements of income.[43]

Mr. Patman was concerned with the concentration of wealth in foundations—thus he proposed taxing them. He was concerned with the use of foundations "to dominate businesses and to escape estate taxes"—thus he proposed limiting foundation holdings "to make it more difficult for our millionaires to bypass the tax collector by handing their intact estates over to tax-free captive foundations." [44]

He listed prominent Americans who had recently died, leaving small fortunes to their private foundations.[45]

Donor and *Donee*	*Millions*
Archibald G. Bush, St. Paul, Minn.—The Bush Foundation, St. Paul, Minn	$118.0
Henry R. Luce, New York, N.Y.—Henry Luce Foundation, Inc., New York, N.Y	68.0
Arthur Vining Davis, Pittsburgh, Pa.—Arthur Vining Davis Foundation No. 2, Pittsburgh, Pa	15.0
Do—Arthur Vining Davis Foundation No. 3, Miami, Fla	30.0
George Gund, Cleveland, Ohio—The George Gund Foundation, Cleveland, Ohio	20.0
Mr. and Mrs. Stephen Currier, New York, N.Y.—Taconic Foundation, New York, N.Y	20.0
Billy Rose, New York, N.Y.—Billy Rose Foundation, Inc., New York, N.Y	20.0
Walt Disney, Los Angeles, Calif.—The Disney Foundation, Los Angeles, Calif	2.4
Total	293.4

He criticized the use of private foundations to perpetuate family control of businesses and he listed a number of private foundations with substantial holdings of nationally-known companies: [46]

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[42] Id.

[43] Tax Reform, 1969: Hearings on the Subject of Tax Reform before the House Comm. on Ways and Means, 91st Cong., 1st Sess. 12 (1969) [hereinafter sometimes 1969 House Hearings].

[44] 1969 House Hearings at 18–20.

[45] 1969 House Hearings at 18.

[46] 1969 House Hearings at 20–21.

B. Altman & Co. (New York)—95 percent of the capital voting stock owned by Altman Foundation, New York City.

American Chain & Cable Co., Inc.—17 percent of the capital voting stock owned by Wm. T. Morris Foundation, New York City.

American National Insurance Co.—35 percent of the common voting stock owned by the Moody Foundation, Galveston, Tex.

Cannon Mills Co.—16 percent of the common voting stock owned by the Cannon Foundation, Inc., Concord, N.C.

Coca-Cola International—16 percent of the common voting stock owned by Emily & Ernest Woodruff Foundation, Atlanta, Ga.

Dana Corp.—17 percent of the common voting stock owned by the Charles A. Dana Foundation, Greenwich, Conn.

Duke Power Co.—57 percent of the common voting stock owned by Duke Endowment, New York City.

Federal Cartridge Corp.—100 percent of the common voting stock and 100 percent of the preferred nonvoting stock owned by Olin Foundation, Inc., New York City.

Ford Motor Co.—100 percent of the class A nonvoting stock owned by the Ford Foundation, New York City.

W. T. Grant Co.—10 percent of the common voting stock and 8 percent of the preferred nonvoting stock owned by the Grant Foundation, Inc., New York City.

Great Atlantic & Pacific Tea Co., Inc.—34 percent of the common voting stock owned by John A. Hartford Foundation, Inc., New York City.

H. J. Heinz Co.—17 percent of the common voting stock owned by the Howard Heinz Endowment, Pittsburgh, Pa.

Hughes Aircraft Co.—100 percent of the common voting stock owned by the Howard Hughes Medical Institute, Miami Beach, Fla.

Hunt Foods and Industries, Inc.—8 percent of the common voting stock owned by the Norton Simon Foundation, Fullerton, Calif.

Irvine Co.—53 percent of the common voting stock owned by the James Irvine Foundation, San Francisco, Calif.

Kaiser Industries Corp.—15 percent of the common voting stock owned by the Henry J. Kaiser Family Foundation, Oakland, Calif.

Kellogg Co.—Approximately 51 percent of the common voting stock owned by W. K. Kellogg Foundation Trust, Battle Creek, Michigan.

S. S. Kresge Co.--22 percent of the capital voting stock owned by Kresge Foundation, Detroit, Mich.

Eli Lilly & Co.—24 percent of the common stock owned by Lilly Endowment, Inc., Indianapolis, Ind.

McDonnell Aircraft Corp.—7 percent of the common voting stock owned by the McDonnell Foundation, Inc., St. Louis, Mo.

Merrill Lynch, Pierce, Fenner & Smith, Inc.—27 percent of the common voting stock owned by the Charles E. Merrill Trust, New York City.

Miller Brewing Co.—47 percent of the common voting stock owned by De Rance, Inc., Milwaukee, Wis.

Ralston Purina Co.—20 percent of the common voting stock owned by the Danforth Foundation, St. Louis, Mo.

Rohm and Haas Co.—19 percent of the common voting stock owned by the Phoebe Waterman Foundation, Philadelphia, Pa.

Sahara Coal Co., Inc.—36 percent of the preferred nonvoting stock and 24 percent of the common voting stock owned by Woods Charitable Fund, Inc., Lincoln, Nebr.

Sun Oil Co.—22 percent of the common voting stock owned by the Pew Memorial Trust, Philadelphia, Pa.

Timken Roller Bearing Co.—10 percent of the common voting stock owned by the Timken Foundation of Canton, Ohio.

United States Sugar Corp.—48 percent of the common stock owned by Charles Stewart Mott Foundation, Flint, Mich.

Wieboldt Stores, Inc.—91 percent of the 6 percent cumulative preferred voting stock owned by Wieboldt Foundation, Chicago, Ill.

Mr. Patman's proposal to tax private foundations and the proposals offered by him and Treasury to limit ownership of business and to require annual distributions of income seemed to evoke the most interest among witnesses and Members.

The testimony of Emerson Andrews, a self-described foundation watcher and former president of the Foundation Center, seems representative of the moderate views. He did not address the issue of

taxation, and he thought the issue of State regulation ought to be given more consideration. He favored adoption of the self-dealing prohibitions and approved prohibiting financial transactions unrelated to the charitable purpose of the organization. He thought the annual payout requirement did not give the charities enough time and suggested instead a three-year average payout requirement. Mr. Andrews approved the limitation of 20 percent ownership of a business providing existing foundations were given reasonable time for divestiture, but did not like Treasury's proposal to deny charitable tax deductions to donors until their gifts were devoted to charitable purposes. He thought this would create major difficulties for the donors, and suggested treating the tax avoidance problems under the self-dealing prohibitions and limitation on business holdings. He opposed the Treasury suggestion to prohibit foundation donors from constituting more than 25 percent of the foundation's management after a 25-year period, arguing that this proposal was unwise, harmful to company-sponsored foundations, and not an appropriate field of supervision for a tax agency.[47]

Mr. David Freeman, President of the Council on Foundations, testified that foundations had supplied over 25 percent of the money that was given to colleges and universities in 1966. He was asked whether he thought that the Treasury recommendations would limit that. He thought that limiting ownership of stock to 3 percent would have a devastating effect on a large number of foundations and would inhibit the growth of new foundations.[48]

The representatives of some big foundations, Alan Pifer of the Carnegie Corp. of New York,[49] J. G. Harrar, of the Rockefeller Foundation,[50] Merrimon Cuninggim of the Danforth Foundation,[51] and McGeorge Bundy of the Ford Foundation,[52] appeared and were questioned about the activities of their foundations.

Alan Pifer and J. G. Harrar testified that their foundations would not be affected by any of the Treasury proposals, but Mr. Pifer questioned whether the proposals limiting ownership of a business and prohibiting donor control of a foundation's management after 25 years might not discourage contributions.

Dana Creel of the Rockefeller Brothers Fund objected to Treasury's proposals limiting ownership of business, denying deductions for gifts of controlled property and restrictions on family participation as trustees after 25 years.[53]

Mr. Cuninggim indicated that the Danforth Foundation would not have trouble meeting the recommendations of the Treasury, but he thought that smaller foundations might have trouble with the 20 percent limitation on business ownership. He was also concerned that the tax treatment of charitable contributions not discourage potential grantors. Although members of the Danforth family constituted less than 25 percent of the foundation's board, Mr. Cuninggim indicated that the family members were among the

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[47] 1969 House Hearings at 90–95
[48] 1969 House Hearings at 104–105.
[49] 1969 House Hearings at 121 et seq.
[50] House Hearings at 245–252.
[51] 1969 House Hearings at 345–349.
[52] 1969 House Hearings at 354 et seq.
[53] 1969 House Hearings at 293–294.

most deeply committed to the foundation's purposes and activities, and he thought that such a limitation might be unnecessarily limiting for small or newly established funds.

Mr. Bundy indicated that the Ford Foundation would have trouble with the self-dealing provisions since it had embarked on a diversification of investment program which involved selling some of the Ford stock which the foundation owned to the Ford Motor Co. and to its stock investment program for salaried employees. The foundation would also have trouble with the 20 percent limitation on equity ownership of a corporation since it held over 85 percent of the equity of the Ford Motor Co. at one time. The foundation anticipated reducing its equity below 20 percent by 1971. However, Mr. Bundy was also concerned that such a provision might limit program-related investments to stimulate development in ghetto areas or to provide jobs in certain areas of the South.[54]

Mr. Bundy thought that the recommendations to limit the income tax deduction for donor-controlled property until the property was disposed of or used for charitable purposes would discourage wealthy individuals from donating any part of their controlling interests in a business. He thought any abuses could be handled by the self-dealing proposals, by an income-equivalent distribution requirement, and by establishment of an independent board of trustees. Interestingly, Mr. Bundy favored the limitation on donor control of the foundation as a minimum requirement.[55]

The Members of the Committee interrogated Mr. Bundy at length on details of certain Ford Foundation grants which had financed voter registration drives in Cleveland before the election of Mayor Carl B. Stokes and grants to ease the transition from public to private life for eight aides of Senator Robert F. Kennedy after his death in 1968.

Thomas A. Troyer, a Washington attorney who had worked on the Treasury proposals while at Treasury, supported the Treasury recommendations. He rejected the argument that foundation holdings of business interests in excess of 20 percent were more valuable and productive than diversified holdings. He explained that in 1964 Treasury found that the overall performance of foundation business interests were less than half as productive as stock included in the Dow-Jones averages. In two-thirds of the cases where foundations held a 50 percent or larger interest Treasury found a zero yield. He pointed out that the Treasury recommendations were not new or revolutionary. They consisted of little more than asking the Committee on Ways and Means to enact the provisions the House had adopted in 1950.[56]

A number of witnesses wanted no limits placed on the full fair market value deduction for gifts of appreciated property. These included the American Association of Museums, the American Association of Fund Raising Counsel, the Baptist Foundation of Texas, the Association of Independent California Colleges, John D. Rockefeller 3rd, and the American Association of Independent College and University Presidents.

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[54] 1969 House Hearings at 356–358.
[55] 1969 House Hearings at 358–359.
[56] 1969 House Hearings at 800–801.

House Report

The Committee on Ways and Means hearings concluded on April 25, 1969. H.R. 13270 was introduced on August 1, 1969 by the chairman and the ranking minority member of the Committee.[57] The bill was a major tax reform bill, and two of the 27 groups of tax reforms included reforms of private foundations and changes in the charitable contribution deduction. The Committee on Ways and Means bill contained three types of changes affecting private foundations.

One type contained provisions which defined private foundations and made distinctions in the types of treatment between private foundations and public charities. The second type gave the Internal Revenue Service ["IRS"] additional tools to gain information about private foundations and public charities; and the third type was a series of excise taxes on certain activities of private foundations.

I. Distinctions between private foundations, private operating foundations and public charities made in the House bill

A. *Definitions of private foundations, operating foundations.* The definition of private foundation listed IRC § 501(c)(3) organizations which were not private foundations; all other § 501(c)(3) organizations were deemed to be private foundations. Organizations which were not private foundations included:

(1) organizations which were eligible to receive contributions under the 30 percent of contributor's adjusted gross income limit in IRC § 170(c);
(2) publicly supported organizations;
(3) organizations organized and operated exclusively for the benefit of an organization described in (1) or (2), and controlled by or operated in connection with an organization in (1) or (2);
(4) organizations organized and operated exclusively for testing for public safety.

The organizations which would qualify under (1) included churches, schools, hospitals and certain medical research organizations, fund-raising organizations for State or local government-supported colleges and universities, States and their subdivisions, and publicly supported charities. Under (2), the Committee stated that an organization which received no more than one-third of its support from investment income and which received more than one-third of its support from the public as gifts, grants, contributions, membership fees, or admissions, not counting income from disqualified persons would be considered a publicly supported organization.[58]

The bill also defined "operating foundation." [59] These were organizations which devoted substantially all of their income (at least 85 percent) directly to the active conduct of their tax-exempt purposes, rather than making grants to other organizations. In addition the organization would have to meet at least one of two additional tests: devote 65 percent of its assets to its activities or derive support from five or more exempt organizations with not more than 25 percent of the support coming from any one exempt orga-

[57] The bill was referred to the Committee on Ways and Means. 115 Cong. Rec. 21871 (1969). On August 2, 1969 the bill was reported to the House. H. Rep't. No. 413, 91st Cong., 1st Sess. 1 (1969).
[58] H. Rep't. No. 413, 91st Cong., 1st Sess. 40–41 (1969).
[59] *Id.* at 26.

nization. As will be discussed later, operating foundations were treated as a hybrid of public charity and private foundation.

B. *Charitable contribution deductions were increased to 50 percent of adjusted gross income for organizations in the old 30-percent category. For private nonoperating foundations the limit was to remain 20 percent of adjusted gross income.* While preserving the distinction between public charities and private foundations made in 1964, the charitable contribution deduction for public charities was increased in order to strengthen the incentive for taxpayers generally and as a trade-off for repealing a special provision providing an unlimited charitable contribution deduction for taxpayers who gave at least 90 percent of their taxable incomes to charitable organizations.[60]

C. *New rules on contributions of appreciated property.* Taxpayers would be required to choose between reducing their charitable contribution deduction to the amount of their cost or other basis of the property or taking a charitable contribution deduction based on the fair market value but including in their tax base the untaxed appreciation on the property given away.

This rule was to apply when a private foundation other than a private operating foundation was the recipient of property, when sale of the property would have resulted in short term capital gain or ordinary income (regardless of the recipient), or when the property was created by the donor (works of art, collections of papers). Donors could escape the private foundation restriction if the foundation distributed an amount equal to the value of its gifts within one year after the year of receipt.

These rules were made because the Committee thought that it was inappropriate for the charitable contribution deduction to provide greater tax benefits than would be realized if the donor sold the property and retained the proceeds.[61]

II. Provisions to aid IRS enforcement in the House bill

A. *Requirement to notify IRS of public charity status.* Organizations formed after May 27, 1969, and existing organizations claiming exemption from private foundation status would be required to inform the IRS of their claim of public charity status. Under existing law the IRS had no way of knowing which organizations claimed tax-exempt status and how many organizations there were. Failure to notify would result in a presumption that the organization was a private foundation.[62]

B. *Rules on termination of private foundation status.* In order to prevent organizations, which were private foundations before consideration of this legislation, from attempting to avoid the provisions of the legislation by giving up their exempt status, the bill required a terminating foundation to repay the Government (with interest) all the tax benefits which resulted from its existence, limited to the net assets of the foundation.

The tax could be abated by distributing the assets to a public charity or by the foundation's becoming a public charity.[63]

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[60] H. Rep't. No. 413, 91st Cong., 1st Sess. 51–52 (1969).
[61] Id. at 53–55.
[62] H. Rep't. No. 413, 91st Cong., 1st Sess. 37–40 (1969).
[63] Id.

C. *Annual information returns.* These were required of every exempt organization and were to include information on substantial contributors, directors, trustees, and other managers and highly compensated employees. There was a $10 a day penalty for failure to timely file, up to a maximum of $5,000. This was to give the IRS information necessary to enforce the new provisions.[64]

III. New excise taxes on private foundations in the House bill

A. *7½ percent tax on net investment income of private foundations, including capital gains and losses.* The Committee report explained that this was intended in part as a tax imposed on the theory that foundations had an ability to pay, and in part as a user fee for the costs of vigorous and extensive enforcement.[65]

B. *Requirement that foundations distribute all income currently, but not less than 5 percent of investment assets.* This was designed to avoid delays in benefits going to charity through such tactics as investing in assets that yielded no current income. The minimum payout was to be adjusted by Treasury based upon money rates and investment yields.[66]

Taxes: Three levels of taxes. First, 15 percent per year of the amount that should have been paid out but was not. Second, 100 percent if not corrected 90 days after notification. Third, essentially results in termination of private foundation status for flagrant and willful acts or repeated violations.[67]

C. *Limitation on stock ownership of the foundation and all disqualified persons to 20 percent of a corporation's voting stock, or 35 percent if someone else was in control.* This was designed to prevent use of foundations to maintain control of businesses, particularly small family corporations. It was feared that some private foundations were being used to maintain corporate control rather than for charitable purposes; that taxable firms competing with the foundation-owned business might suffer as a result of the tax advantage of private foundations; and that if the managers emphasized the charity role, the business would suffer, and if they emphasized business success the charitable purposes might suffer. Divestiture was to occur in 10 years for existing holdings and 5 years for future holdings. The Committee on Ways and Means excepted two foundations from this provision.

Taxes: There was to be a three-level set of taxes on the foundation for excess business holdings. First, 5 percent per year on the amount involved until the violation was corrected. Second, 200 percent if act nor corrected with 90 days of notice of first level tax. Third, repayment of all tax benefits ever received or distribution of assets to a public charity for willful repeated act or flagrant violations.[68]

D. *Prohibitions on self-dealing between the foundation and certain disqualified persons.* This provision was intended to minimize the need to employ a subjective standard like the arm's-length test which had allowed those who control a foundation to use it for

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[64] Id. at 36–37.
[65] Id. at 19.
[66] Id. at 25.
[67] Id. at 26–27.
[68] Id. at 27–31.

their own benefit in situations where although the price was fair, the donor received a benefit which he could not get in the market place.

Taxes: There was to be a three-level set of taxes on any self-dealer. A separate three-level set of taxes was to be imposed on any foundation manager who knowingly participated in the self-dealing. First, 5 percent per year on the self-dealer until the violation was corrected; 2½ percent on the foundation manager, limited to $10,000. Second, 200 percent on the self-dealer if not corrected within 90 days of notice of first-level tax; 50 percent on foundation manager, if he refused to correct, limited to $10,000. Third, foundation could be forced to repay all tax benefits ever received for willful repeated acts or flagrant violations.[69]

E. *Limitations on the investment of assets which jeopardize exempt purposes.* This was the same provision as in existing law, but three levels of sanctions were to be applied rather than automatic loss of exemption.[70]

F. *Prohibitions on spending for lobbying, electioneering (including voter registration drives), grants to individuals not made on an objective basis, and grants to other organizations unless the foundation supervised the recipient's use of the money* (i.e. the expenditure responsibility requirement). These activities were thought to be improper for private foundations; however, there were certain exceptions written into the bill designed to allow organizations such as the League of Women Voters and the Southern Regional Council to conduct voter registration drives. The three levels of sanctions were thought to be more proportional to possible offenses than existing law requiring loss of exemption.[71]

House Action

The bill was considered under a closed rule and therefore there were no floor amendments to these provisions.

Senate Hearings

When Senate Finance Committee hearings were held on the House bill, most of the testimony on foundations was a reaction to the House bill provisions.[72]

Treasury testified that the House-proposed 7½ percent audit tax on private foundations would raise more revenue than they would spend auditing private foundations.[73]

There were a few cheers for the reforms proposed by the House. The National Tax Equality Association, represented by Mortimer M. Caplin, applauded the extension of the unrelated business income tax to all exempt organizations, the taxing of debt-financed acquisitions, the divestiture of private foundations business holdings in excess of 20 percent of a business, and taxing the advertising income of tax-exempt publications.[74] Representatives of the

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[69] Id. at 20–24.
[70] Id. at 31.
[71] Id. at 31–37.
[72] Tax Reform Act of 1969: Hearings on H.R. 13270 before the Senate Finance Comm., 91st Cong., 1st Sess., pt. 1, 2, 6 (1969) [hereinafter "1969 Senate Hearings"].
[73] 1969 Senate Hearings, 499, 565.
[74] 1969 Senate Hearings, 1064–1067.

commercial newspapers approved taxing the advertising income of tax-exempt publications, feeling that these organizations competed unfairly with commercial newspapers.[75]

A group of representatives of private foundations, including representatives from the Ford, Carnegie, and Rockefeller Foundations as well as many others, formed the Foundations Coordinated Testimony Group and submitted over 100 pages of testimony on the contributions of foundations; the possible harm to schools and universities receiving foundation money; the fact that the tax on foundations would leave them with less money to distribute; the fact that prohibiting any attempt to influence legislation might prevent foundations from studying controversial problems which might be the subject of legislation, from recommending legislation as a solution to social problems, and from attempting to educate the public on such topics; the partial prohibition against grants to individuals might handicap programs providing fellowships and awards; and the difficulty in exercising expenditure responsibility.[76] The Members were particularly interested in obtaining figures on the growth in assets of the large foundations and in discussing the various activities of the foundations.

Brookings Institution and a number of other academic institutions not organizationally connected with universities and colleges appeared, fearing that they might be unintentionally included in the definition of private foundation. Other organizations, including the League of Women Voters, had the same concern for different reasons.[77]

A number of private foundations opposed the divestiture requirements and the minimum payout requirements, usually on the grounds that their good works would have been limited if they had not accumulated funds at some times or if they had been required to dispose of accretions to principal as a result of capital gains. Some, like the Hormel Foundation, had attachments to a particular business or community and felt a responsibility to the employees and the community to continue managing the business for their benefit.[78]

The last person to testify was Peter G. Peterson, President of Bell & Howell Corp., testifying in his capacity as chairman of a study on private foundations funded by John D. Rockefeller 3rd and several major foundations called the Commission on Foundations and Private Philanthropy and which became known as the Peterson Commission. His testimony was a preliminary report on his commission's findings. Those findings were favorable to foundations: the existence of abuses was relatively infrequent. Nevertheless, the commission's preliminary recommendations seemed to echo the House bill. For example, he recommended a high annual payout requirement—in the range of 6 to 8 percent of a foundation's assets. He recommended that the Treasury have authority to adjust the payout rate based on standards set by Congress. He believed that a high payout requirement would mitigate the problems

[75] 1969 Senate Hearings, 1109–1125.
[76] 1969 Senate Hearings, 5344–5519.
[77] 1969 Senate Hearings, 5551–5597; 5891–5898.
[78] 1969 Senate Hearings, 5716–5727.

of perpetual existence of foundations because only the most productive would survive, and the problems of foundation control of corporations and lack of diversification would be met because foundations with low or unproductive rates of return would be forced to diversify to meet the payout requirement.

Mr. Peterson endorsed increased foundation reporting and disclosure and the prohibitions against self-dealing. He also endorsed increased Internal Revenue Service audits, but questioned the necessity of an audit fee as high as 7½ percent. Mr. Peterson thought that the sanctions for violations of the private foundation rules in the bill ought to be reworked and that the objective ought to be to make the charity whole, not to collect taxes. Similarly, he thought the penalties should be fines and not taxes, and that the penalties should not necessarily be measured by the amount involved.[79]

The Senate Report

As reported by the Senate Committee of Finance the bill was substantially similar to the bill passed by the House. There were three major substantive differences.

1. Limit the life of private foundations to 40 years.

The report of the Finance Committee indicates that questions had been raised about whether foundations should be exempt from income taxes in perpetuity. The problem was that with a permanent tax-exempt life, foundations might grow to such an extent that they would have an undue influence on the private economy and on government decisions. The report questioned whether the funds which were donated to private foundations with the benefit of income and estate tax deductions for charitable contributions should not at some point be used for the charitable purposes for which they were donated. As it was, usually only the income generated by these funds was going to charitable purposes. The committee concluded that in order to be able to continue its tax exempt life beyond 40 years, a private foundation should have been able to attract sufficient public support to become a public charity, should have created an appropriate operating function for itself, or should have expended its assets for the charitable purpose for which it was created.[80]

2. Call the tax an audit fee and decrease it to one-fifth of one percent of the noncharitable assets of the private foundation.

The committee thought that it was important to distinguish between a "user charge" and a withdrawal of the income tax exemption from private foundations. The committee thought that continuation of the income tax exemption was appropriate, but that a charge measured by the value of assets to be supervised was an appropriate way to collect the costs of IRS supervision from the foundations.[81]

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[79] 1969 Senate Hearings, 6053–6182.
[80] S. Rep't. No. 552, 91st Cong., 1st Sess. 25–26 (1969).
[81] Id. at 27.

3. Charitable contribution rules liberalized.

The Finance Committee made a number of changes in the House version of the bill. The most significant were the rules on donations of appreciated property. The Committee would have limited the income tax deduction for donations of appreciated property to public charities to 30 percent only for the portion attributable to the appreciation, not the portion attributable to cost. The Committee also eliminated three of five situations in which the House had proposed taking appreciation of donated property into account for income tax purposes.[82]

4. Other Changes.

There were many other changes including, to name a few, an additional self-dealing requirement, changes in the definitions of disqualified persons, extensions in the divestiture schedule for excess business holdings in certain cases, liberalized rules and penalities for investments which jeopardize the charitable purpose of the organization, deletion of the House provision permitting nonpartisan voter registration drives conducted by private foundations, an addition to the types of organizations which could be private operating foundations, and modifications in the rules requiring public disclosure of the names of contributors to public charities.

Senate Action

On the Senate floor, the private foundation and charitable deduction provisions of H.R. 13270 were amended again. The proposal to limit the life of the tax-exemption for private foundations was deleted on the Senate floor by a vote of 69–18. The amendment was introduced by Senators Mondale, Curtis, Percy and Hollings. Apparently Senator Javits proposed a similar amendment. Senators Long and Gore were the principal defenders of the 40-year limitation.[83]

The Senate also decreased the proposed audit fee for future years to one-tenth of one percent, increased the minimum payout requirement to six percent, permitted certain private foundations to conduct voter registration drives, and made several other amendments.

Public Law 91–172

The Tax Reform Act of 1969 made major changes in the tax treatment of private foundations and the rules on charitable contributions to tax-exempt organizations. As discussed earlier, the types of changes can be divided into three major categories.

First, although a rough sort of distinction between private foundations and public charities had existed since 1943, for the first time "private foundation" was defined statutorily. Along with this definition came a definition of "operating foundation." For lack of a better term, organizations which do not fall into these two categories are referred to as "public charities," although this is not a statutory term. In addition to these statutory definitions, the Act

[82] Id. at 78, 80–82.
[83] 115 Cong. Rec. 35946–7, 37197–37205 (Nov. 26 and Dec. 5, 1969).

created additional differences in the treatment of charitable contributions to private foundations and public charities.

The second major change, which also added to the differences in public charities and private foundations, was a series of excise taxes imposed on private foundations. All but one of these were designed to enforce substantive limits on the activities and conduct of private foundations. These provisions imposed a tax on investment income; required divestiture of excess business holdings; required mandatory distributions of foundation income; prohibited self-dealing; prohibited investments which jeopardized the charitable purpose of the organization; prohibited political and lobbying expenditures and required supervision of grants.

The third series of changes was designed to give the Internal Revenue Service additional tools to gain information about private foundations and public charities.

I. Distinctions between private foundations, private operating foundations and public charities

Under the changes made by the Tax Reform Act of 1969, organizations classified under section 501(c)(3) of the Internal Revenue Code could be divided into three categories: public charities, private operating foundations, and private foundations. Public charities have relatively few restrictions on their operations and donors to public charities receive the most favorable income tax treatment. Operating foundations enjoy a middle treatment. Their donors receive the more favorable income tax treatment and they are not subject to two of the private foundation restrictions. Donors to private foundations receive less favorable income tax treatment, and private foundations are subject to a series of six possible excise taxes.

A. *Definition of private foundations and operating foundations.* The term private foundation is defined in the negative: all IRC § 501(c)(3) organizations which do not fit within the exceptions are deemed to be private foundations. Organizations which are not private foundations include: [84]

(1) Organizations which are eligible to receive contributions under 50 percent of the contributor's income limitation of IRC § 170(b);
(2) Publicly supported organizations;
(3) Organizations organized and operated exclusively for the benefit of an organization described in (1) or (2);
(4) Organizations organized and operated exclusively for testing for public safety.

The organizations which qualified under (1) include churches, schools, hospitals and certain medical research organizations, fundraising organizations for State or local government-supported colleges or universities, States and subdivisions, and publicly supported charities. Under (2), an organization which receives no more than one-third of its support from investment or unrelated business income, if more than one-third of its support comes from the public as gifts, grants, contributions, membership fees, or admissions, not counting income from disqualified persons, would be considered a publicly supported organization.

[84] P.L. 91–172, § 101, 83 Stat. 496, adding IRC § 509.

The Act also defined "operating foundation." [85] These are organizations which devote substantially all (at least 85 percent) of their earnings directly to the active conduct of their tax-exempt purposes, rather than making grants to other organizations. In addition, the organization has to meet one of three alternative tests. First, at least 65 percent of its assets must be devoted to activities for which it is organized or to functionally related businesses (e.g. Colonial Williamsburg, Callaway Gardens, Jackson Hole). Or, second, the organization normally receives substantially all of its support from five or more exempt organizations and the general public and not more than 25 percent of its support comes from any one exempt organization (e.g. special purpose foundations such as associations of libraries, learned societies). Or, third, the organization's endowment is no more than adequate to meet current operating expenses (e.g. Longwood Gardens, Sleepy Hollow Restoration, and research organizations.)

Under the 1969 Act, there were three tax advantages in being a private operating foundation. First, an operating foundation was eligible to receive contributions up to the 50 percent of income limit. Second, the operating foundation did not have to expend all of its current income. Third, operating foundations could receive grants from other private foundations without being required to spend the money immediately.

B. *Charitable contribution deduction rules.* The Tax Reform Act of 1969 increased the limitation on the charitable contributions deduction for individual taxpayers from 30 percent of adjusted gross income to 50 percent, providing the gift was made to a public chairity or an operating foundation. The 30-percent limit remained in effect for contributions of capital gain property, unless the taxpayer elected to exclude a portion of the capital gain in computing the value of the contribution. Contribution deduction limits for gifts to private foundations remained 20 percent of the taxpayer's adjusted gross income, unless with 2½ months after the year of receipt the private foundation distributed all of its contributions to a public charity or an operating foundation. In that case, the higher limit would apply.[86]

C. *Rules on contributions of appreciated property.* Major changes were made in the rules about donating property to charitable organizations. No longer could taxpayers assume that the fair market value rule would govern the valuations of their gifts to charities. The tax committees learned that the combined effect of not taxing appreciation while allowing a deduction for the full fair market value of contributions of appreciated property allowed tax benefits greater than those available if the taxpayer donated cash.[87]

In some cases involving gifts of ordinary income property, such as inventory or works created by the donor, it was possible for a taxpayer to have a greater after-tax profit by making a gift of appreciated property than by selling the property, paying the tax on the gain, and keeping proceeds. This was partially the result of the

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[85] Pub. L. 91-172, § 102, 83 Stat. 506, adding IRC § 4942(j).
[86] H. Rep't No. 413, 91st Cong., 1st Sess. 51-52 (1969); S. Rep't. No. 552, 91st Cong., 1st Sess. 78 (1969).
[87] S. Rep't No. 552, at 80; H. Rep't No. 413, at 53.

fact that tax rates on ordinary income could exceed 50 percent. For example, a taxpayer in the 70-percent bracket could make a gift of $100 of inventory ($50 cost basis). He would get a $100 deduction which would save him $70 of taxes for giving away property which cost him $50, for a net benefit of $20. If the taxpayer sold the inventory and kept the proceeds, he would have been out of pocket for the $50 cost of the inventory plus 70 percent of the $50 gain or $35, for a cost of $85, net cash benefit of $15. If the taxpayer gave away $100 cash, his net cost would be $30. If the taxpayer sold the inventory and gave away the proceeds, his net cost would be $50 cost of inventory, plus $35 tax on gain, minus $70 tax benefit for donation, for a net cost of $15.

Similar tax benefits were available for bargain sales of appreciated property. The taxpayer could sell an item to a charity for the cost basis and claim the appreciation as a charitable contribution deduction. The taxpayer incurred no income taxes on the sale because he simply recovered his basis; and although the appreciation was never taxed, it gave rise to a tax deduction.

Because Congress did not believe that the charitable contribution deduction should provide greater—or even nearly as great—tax benefits than would be realized if the property were sold and the proceeds retained, Congress narrowed the tax incentives to make bargain sales of appreciated property to charities, to give appreciated property to charity if its sale would have resulted in ordinary income, or to make gifts of appreciated property to private foundations.[88]

The House and the Senate took different approaches in how to treat appreciated property. The differences encompassed both how to take the appreciation into account for tax purposes and which types of appreciation should be taken into account. Both the House and the Senate bills agreed appreciation should be taken into account in two situations: (1) gifts to private foundations unless certain exceptions were met; and (2) gifts of ordinary income property (e.g. inventory, short-term capital gain property, donor-created property) to any exempt organization. Both houses agreed appreciation should not be taken into account for gifts of non-tangible personal property (e.g., stock) to public charities where the appreciation was long-term capital gain.

The areas of disagreement involved gifts of tangible personal property where the appreciation would have been long term capital gain; gifts of future interests where the appreciation would have been long term capital gain; and the treatment of bargain sales. The House proposed taking these forms of appreciation into account and the Senate would not have done so. For the most part the House version was adopted by the conference committee.

The issue of gifts of tangible personal property (e.g., paintings, books, cars) where the appreciation would have been long term capital gain was compromised. If the property would be used in the exempt function of the public charity, the appreciation did not have to be taken into account and a full fair market value deduction could be taken. If the property would not be used in the organization's exempt function, the appreciation would have to be

[88] H. Rep't. No. 413 at 54; S. Rep't. No. 552 at 80–81.

taken into account by reducing the value of the gift for purposes of the charitable contribution deduction.[89]

II. Excise taxes on private foundations

A. *Excise tax on investment income.*[90] The conference version of this tax was a tax of 4 percent of net investment income of each private foundation for each taxable year. This appears to have been a straight compromise between the 7½ percent tax proposed by the House and the one-tenth of one percent proposed by the Senate.

B. *Requirement that foundations distribute all income currently.*[91] Foundations have one taxable year after the year of receipt in which to distribute their income. To prevent foundations' avoiding the distribution requirements by investing in growth stocks with no dividends, the statute imposed a minimum distribution requirement equal to 6 percent of noncharitable assets. For existing foundations, this requirement was to be phased in over five years. Foundations which distribute amounts in excess of income can carry over the excess distribution for five years.

Sanction—Failure to distribute enough income will result in a tax on the foundation equal to 15 percent of the undistributed income for each year it was not distributed. If the first-level tax is imposed, and the situation is not corrected within the 90-day correction period, then a second-level tax of 100 percent is imposed. Flagrant or willful violations are treated as termination of private foundation status cases, described later.

This requirement was enacted because the reasonable accumulation standard of the Revenue Act of 1950 was not very effective in speeding charitable contributions to charitable beneficiaries and because loss of exempt status, which was the only available sanction for failure to distribute enough income, was thought to be too harsh a punishment for minor violations.

C. *Limits on business holdings.*[92] The 1969 Act permits private foundations and all disqualified persons together to hold a 20 percent interest in the voting stock of a corporation. (Disqualified persons will be defined below under the self-dealing provisions.) If an unrelated party has effective control of the corporation, then the private foundation and all disqualified persons may own up to 35 percent of the voting stock.

A private foundation can hold an unlimited amount of nonvoting stock provided that disqualified persons do not hold more than 20 percent of the voting stock. If these limits are exceeded, the private foundation must divest itself of its excess business holdings. There are similar limits on interests in partnerships and estates and certain trusts. There is a de minimis rule which exempts foundations which hold 2 percent or smaller interests from the excess business holding rules, providing that all the holdings of related private foundations are aggregated for purpose of this rule.

Sanction—If the foundation has excess business holdings, the foundation must pay an initial tax of 5 percent of the value of any

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[89] H. Rep't. No. 782, 91st Cong., 1st Sess. 294 (1969).
[90] P.L. 91-172, § 101, 83 Stat. 498, adding IRC § 4940.
[91] P.L. 91-172, 83 Stat. 502, adding IRC § 4942.
[92] P.L. 91-172, 83 Stat. 507, adding IRC § 4943.

excess business holdings each year. If the excess is not disposed of by the end of the tax year in which the initial tax is imposed, there is a second-level tax equal to 200 percent.

Two major exceptions to the excess business holding rules are made in the definition of a business enterprise. A business enterprise does not include functionally-related businesses (such as the Inn and Lodge at Colonial Williamsburg, museum cafeterias and snack bars, advertising in a foundation's journal) or a trade or business where 95 percent of the income is from passive sources (such as a passive holding company).

The House bill called for more rapid divestiture than did the Senate. The conference substitute was even more liberal than the Senate version. The statute set up a two-step divestiture program:

First, the statute provided that where a foundation and disqualified persons held more than 20 but less 50 percent of the voting stock, the foundation could continue to keep its existing holdings for 10 years but it could not increase them. If the combined foundation and disqualified person holdings were greater than 50 percent up to 75 percent, the holdings had to be reduced to 50 percent by the end of a 10-year period. If the combined holdings were more than 75 percent, the reduction to 50 percent did not have to occur for 15 years. If the foundation itself held more than 95 percent of a corporation's stock, then the foundation had 20 years to reduce the combined holdings to 50 percent.

Second, after the end of the 10-, 15- or 20-year period provided for in stage one, the foundations and disqualified persons had 15 additional years to reach the final limitations for foundations existing on May 26, 1969. If the disqualified persons owned more than 2 percent of the stock, then the foundation could not own more than 25 percent of the stock. (The combined holdings could not exceed 50 percent.) If disqualified persons owned 2 percent or less of the stock, then the combined holdings could not exceed 35 percent; however, if the disqualified persons ever acquired more than 2 percent of the stock, the permissible foundation holdings would drop to 25 percent and the combined holdings would still be limited to 35 percent.

If a foundation acquired excess business holdings by gift or bequest after the 1969 Act, generally the foundation had five years to dispose of the excess holdings. There are exceptions for holdings acquired under an irrevocable trust or a will executed prior to May 26, 1969.

D. *Prohibition on self-dealing.*[93] The Act prohibited six types of transactions between private foundations and certain related persons (called disqualified persons in the statute):

(1) selling, exchanging, or leasing property;

(2) lending money or extending credit;

(3) furnishing goods, services or facilities;

(4) paying compensation or expenses of a disqualified person;

(5) transferring the foundation's income or assets for use by a disqualified person;

(6) paying government officials.

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[93] P.L. 91-172, § 101, 83 Stat. 499, adding IRC § 4941.

The Finance Committee had added a seventh provision—paying any taxes of a disqualified person imposed by the new private foundation rules. This provision was dropped in conference in the belief that payment of taxes would be covered by the prohibition on transfers for the benefit of disqualified persons.

A disqualified person was defined as any one of the following persons or members of the families of persons described in (a), (b), or (c):

(a) a substantial contributor to the foundation;

(b) a foundation manager (i.e. any officer, director, trustee, or person with similar responsibilities);

(c) an owner or more than 20 percent of a corporation, partnership, or the trust which is a substantial contributor;

(d) a corporation, partnership, trust or estate in which any of the above own more than 25 percent; or

(e) certain government officials.[94]

A member of the family included an individual's spouse, ancestors, lineal descendants, and spouses of lineal descendants. These provisions were added in order to minimize the need to apply the subjective arm's-length standards of conduct, to avoid the temptation to misuse private foundations for non-charitable purposes, to provide a more rational relationship between sanctions and improper acts, and to make it possible to enforce the law more efficiently.

Sanctions—The first level tax is equal to 5 percent of the amount involved, and it is to be imposed on disqualified persons for each act of self-dealing each year. If a foundation manager knowingly participates in an act of self-dealing between a disqualified person and the private foundation, there is a first level tax equal to 2½ percent of the amount involved, limited to $10,000. The second level tax, imposed on the disqualified person only if there is no correction during the correction period, is equal to 200 percent of the amount involved. A second level tax equal to 50 percent is imposed on the foundation manager if he refuses to agree to any part of the correction. This tax on the foundation manager is also limited to $10,000.

E. *Prohibitions on unsound investments.*[95] Prior to the 1969 Act, a private foundation could lose its exemption if its accumulated income was invested in a manner which would jeopardize its charitable purpose (e.g. risky investments where the corpus might be lost). In the 1969 Act Congress imposed limited sanctions rather than loss of exemption because they wanted to be sure that foundations invested their income and corpus in a manner which would benefit charity. Program-related investments such as student loans, investments in low-income housing, or loans to small businesses where commercial funding is unavailable are not to be considered jeopardizing investments.

Sanctions—The first level tax on the foundation is equal to 5 percent of the amount involved. Failure to correct would lead to a second level tax on the foundation equal to 25 percent. Foundation managers are subject to a 5 percent tax if they knowingly partici-

[94] P.L. 91-172, § 101, 83 Stat. 515, adding IRC § 4946(a).
[95] P.L. 91-172, § 101, 83 Stat. 511, adding IRC § 4944.

pate in making such an investment, limited to $5,000. The second level tax on foundation managers is also equal to 5 percent with a cap of $10,000.

F. *Political expenditures and expenditure responsibility.*[96] The 1969 Act prohibits foundations from engaging in political activities, including lobbying, electioneering, and grassroots campaigning. It also requires grant-making foundations to assume the responsibility that their grantees will use their grants properly. This means foundations cannot make grants to individuals for travel or study unless the grants are for scholarships or fellowships to be used for (1) study at an educational institution; (2) prizes or awards in recognition of achievement; or (3) made to achieve a specific purpose such as a report or to improve the skills or talents of the grantee. If grants are made to other private foundations, then the grantor must exert all reasonable efforts and establish adequate procedures to see that the grant is spent for the purpose for which it was made; obtain full and complete reports on how the funds were spent; and report the grants to the IRS. Otherwise these expenditures are subject to the tax.

Sanction—There is a two-level tax on the foundation: 10 percent of the taxable expenditure for initial violations; 100 percent for failure to correct. Foundation managers who knowingly agree to make a taxable expenditure are subject to an initial tax of 2½ percent, up to $5,000. Failure to agree to correction leads to a 50 percent tax, up to a $10,000 maximum.

Prior law had prohibited participation in political campaigns and engaging in substantial lobbying, but the only penalty had been loss of exemption. Erratic enforcement was a problem. In the hearings Members were concerned about reports that the Ford Foundation had financed voter registration drives in Cleveland that led to the election of Mayor Carl B. Stokes; that the Ford Foundation had provided grants to eight aides of Senator Robert F. Kennedy, after his death in 1968, to ease their transition from public to private life; that the Richmond Foundation had used election-time gifts to gain publicity for its founder's unsuccessful campaign for a seat in the House of Representatives.[97]

These provisions were designed to reemphasize that political and lobbying activities were prohibited; to set standards for grants to individuals; and to require the foundation to exercise expenditure responsibility over grants to other private foundations. Instead of loss of exemption, the 1969 Act imposed graduated sanctions, tied to the magnitude of the offense.

III. Provisions to aid IRS enforcement.

A. *Requirement to notify the IRS of public charity status.*[98] Organizations formed after October 9, 1969, and existing organizations claiming not to be private foundations were required to inform the IRS of their claim to public charity status. Failure to notify resulted in a presumption that the organization is a private foundation. Under existing law the IRS had no way to find out which organiza-

[96] P.L. 91-172, § 101, 83 Stat. 512, adding IRC § 4945.
[97] 1969 House Hearings, 368-369, 373-377, 213-215, 1043-1051.
[98] P.L. 91-172, § 101, 83 Stat. 494, adding IRC § 508.

tions claimed tax-exempt status and how many organizations there were.

B. *Rules on termination of private foundation status.*[99] Congress was concerned that organizations with large endowments might prefer to give up their exempt status rather than continue to operate as a charity under the new private foundation restrictions. They might choose to become taxable and continue operating in the future, or they might operate as exempt under a section other than 501(c)(3) since there was no retroactive penalty for not maintaining their status.

In order to penalize private foundations for not maintaining their private foundation status or for flagrant and willful violations of the excise tax prohibitions, the new law required a private foundation desiring to terminate its private foundation status to become a public charity, to donate all of its assets to a public charity, or to pay a termination tax equal to the aggregate tax benefits it had ever received, plus interest. Aggregate tax benefits include exemption of the foundation from income taxes and deductions in income, gift, and estate taxes ever taken by all substantial contributors.

C. *Public disclosure requirements.*[100] Under prior law, only certain organizations (essentially similar to what later became private foundations) were required to file information returns. The 1969 act required additional charitable organizations to file annual returns. The information return requirements were expanded to include information on substantial contributors, trustees, directors, managers, and highly compensated employees. This information was to be made public; however, public charities may choose to disclose the names of substantial contributors only to the IRS.

In addition, private foundations with assets in excess of $5,000 at any time during the year were required to file an annual report. The annual report required additional information, including: lists of assets at book and market values; list of grants, grantees, and purposes; lists of foundation managers who are substantial contributors or who own at least 10 percent of an entity in which the foundation owns at least a 10 percent interest. This report had to be available to the public at the foundation's office for at least 180 days, and the foundation had to publicize the report's availability.

The penalties were $10 a day for failure to file the information return or the annual report or for failure to make the information available to the public, up to a maximum of $5,000 for each report. There were additional penalties for failure to file after a reasonable demand, for willful failure to file, and for furnishing false information.

Post 1969 Legislative Developments

During the period since 1969, Congress has acted to modify the operation of particular provisions of the Internal Revenue Code governing private foundations but retained the basic law as enacted in 1969. Among the most significant changes made since 1969

[99] P.L. 91-172, § 102, 83 Stat. 492, adding IRC § 507.
[100] P.L. 91-172, § 101, 83 Stat. 519-521, adding IRC §§ 6033, 6056.

were (1) reduction of the excise tax on net investment income from 4 to 2 percent;[101] and (2) changes in the distribution requirement's minimum investment return from a variable percentage of investment (determined by the Treasury Department and based on a six percent 1969 return rate and subsequent changes in money rates and investment yields) to five percent of its net investment assets.[102] These and other changes can be traced, at least in part, to reactions of private foundations to the operation of the 1969 law. Most of the attention in post 1969 congressional hearings has been centered on testimony from foundations and their beneficiaries.

1973 and 1974 Hearings

In 1973 the House Committee on Ways and Means conducted a lengthy series of hearings on general tax reform, including two days on private foundations and charitable contributions,[103] where the operation of the 1969 law and complaints from foundations as to its impact were reviewed. The following year hearings were held by the Senate Subcommittee on Foundations to review the impact of the 1969 law, inflation, and falling stock prices on foundations.[104] During the course of these hearings, witnesses representing foundations and their beneficiaries were particularly critical of the 4 percent excise tax on net investment income and the minimum payout requirement.

During the 1973 hearings before the Ways and Means Committee, Randolph Thrower, a former Commissioner of Internal Revenue and then counsel to the Southeastern Council of Foundations, noted that the 4 percent tax was enacted to pay the cost of IRS compliance program for foundations, but the tax generated over four times the amount used to monitor private foundations and about three times the cost amount attributable to monitoring the entire field of exempt organizations, including everything from churches to labor unions and social clubs. The effect, he maintained, was to tax the charity depriving it of resources it might use for charitable beneficiaries. IRS used the money not simply to police private foundations but to audit social clubs, unions, business leagues and the like, and to raise money for the general fund. Such a levy, Mr. Thrower suggested, is not consistent with traditional treatment of charities and congressional intent in 1969 and should be modified to make it in fact an audit fee, raising only those monies necessary for policing private foundation activities.[105]

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[101] P.L. No. 95-600, § 520(a), 92 Stat. 2884.

[102] Originally, the minimum payout was the higher of the minimum investment return, calculated as indicated in the text and reduced by specified federal taxes, or adjusted net income. The variable rate based on a 1969 return rate of 6 percent was changed to a straight 5 percent by Pub. L. No. 94-455, § 1303(a), 90 Stat. 1715. Section 823(a)(1) of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 351, eliminated the alternative use of adjusted net income from the minimum payout requirement so that the present payout is equal to the 5 percent minimum investment return.

[103] General Tax Reform Part 14: Hearings before the House Comm. on Ways and Means, 93rd Cong., 1st Sess. (1973) [hereinafter cited as 1973 Tax Reform Hearings].

[104] Private Foundations: Hearings before the Subcomm. on Foundations of the Senate Comm. on Finance, 93rd Cong., 2nd Sess. (1974) [hereinafter cited as 1974 Private Foundations Hearings]; and Impact of Current Economic Crisis on Foundations and Recipients of Foundation Money: Hearings before the Subcomm. on Foundations of the Senate Comm. on Finance, 93rd Cong., 2nd Sess. (1974) [hereinafter cited as 1974 Impact Hearings].

[105] 1973 Tax Reform Hearings, Part 14 at 5781-5801, esp. 5786-87.

Similar views were expressed by Robert F. Goheen, Chairman, Board of Directors, Council on Foundations, who noted that in 1969, Treasury had recommended a 2 percent excise tax, and even that would generate more than twice the amount needed. In his view, audits were necessary and there was no objection to a fee earmarked for that purpose; but a tax on charitable activities set a bad precedent which could be extended beyond private foundations to others.[106]

While these and other witnesses from foundations and their beneficiaries called for reduction of the 4 percent tax, Representative Wright Patman, whose earlier legislative activities had been of substantial significance in focusing attention on private foundations and enactment of the 1969 provisions, urged Congress to hold the line, using the excess from the 4 percent excise tax for grants to states to enable them to devote more attention to the supervision of foundations. He called for earmarking the tax for auditing foundations and for grants to state agencies responsible for day to day supervision of foundations.[107]

The second area of general concern to witnesses before congressional committees in 1973 and 1974 was the payout requirement. Under the 1969 Act, foundations were subjected to a penalty tax on undistributed income. The distributable amount was the greater of the minimum investment return or adjusted net income less certain taxes. Minimum investment return was determined by multiplying the net value of assets by the applicable percentage for the year. The percentage was set at 6 percent for 1970 and was to be adjusted by the Secretary in accordance with changes in money rates and investment yields.

In testimony before congressional committees in 1973 and 1974, representatives of foundations and their beneficiaries objected to the statutory minimum and Treasury's method of determining the applicable percentage. They argued that 1) the statutory formula did not account for inflation; 2) the long range real rate of return on investment rather than more volatile year-to-year rates should be used; 3) Treasury was using yields on intermediate U.S. Government securities in establishing the applicable percentage, a higher yield than a balanced portfolio would have received; 4) over time the real rate of return on capital market instruments is 4½ to 5 percent; 5) the payout requirement forces foundations to invade the corpus in order to satisfy distribution requirements which will reduce foundation resources and their ability to respond to needs of beneficiaries.[108]

Foundation officials testified in 1974 that the value of their assets was decreasing while payout requirements were rising. F. Lee Jacquette of the Carnegie Foundation, testifying before the Senate Subcommittee on Foundations in 1974, stated that the

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[106] Id. at 5801–5852, esp. 5803–04, 5809.

[107] 1973 Tax Reform Hearings, Part 17 at 6773–6817.

[108] See e.g., 1973 Tax Reform Hearings Part 14 at 5787–89 [testimony of Randolph Thrower] and 5804, 5809–11 [testimony of Robert Goheen of the Council on Foundations indicating support for a payout requirement but arguing that the rule adopted in 1969 was based on erroneous assumptions and required high payouts relative to current income, necessitating invasion of corpus]. 1974 Impact Hearings 59–60 [statement of John Knowles, President Rockefeller Foundation] and 124–138 [statement of H. Lawrence Fox on behalf of the Hormel Foundation, Kellogg Foundation, Kresge Foundation and others].

market value of its assets was $227 million compared to $331 million ten years earlier.[109] Dr. Landrum Bolling of Lilly Endowment stated that the Endowment had spent $29 million in capital as well as all its income during the first 10 months of 1974.[110]

These and other witnesses cited falling stock prices, inflation and higher interest rates, and the effect of minimum payout requirements as a reason for concern, urging reconsideration of the latter. Mr. Jacquette suggested the higher of current cash yield or five percent return as a minimum payout alternative.[111] John B. Huffaker, an attorney with foundation clients, citing similar concerns, suggested a fixed rate of return of 5 percent for a six year period to determine minimum payout.[112]

Other concerns were addressed by various witnesses, including the paper work burden;[113] problems of private foundations providing long term care for the indigent/elderly/children in meeting the minium payout requirement;[114] problems involved where foundations owned property designed particularly for use by disqualified persons;[115] the problem of expenditure responsibility and program restrictions and the tendency to encourage foundations to support traditional programs and avoid different and innovative efforts;[116] the required reports on grant use in cases of small, direct relief of the poor for such things as medical treatment, which were believed to infringe on the privacy of recipients;[117] improved access to the Tax Court in cases involving adverse determination of exempt status;[118] increasing incentives for charitable contributions;[119] the short period for divestiture of new gifts of excess business holdings;[120] application of divestiture to existing, well performing foundations;[121] and possible exception from private foundation status for museums.[122] Suggestions were also heard that perhaps foun-

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[109] 1974 Impact Hearings 166.

[110] Id. at 179.

[111] Id. at 164, 167-68.

[112] Id. at 109-113.

[113] 1974 Private Foundations Hearings 93, 95 [Sen. Hartke and Joe G. Dempsey, Executive-Director of the Los Angeles Inter-Faith Foundation].

[114] Id. at 78-91 [testimony of Karl R. Ross of the Myron Stratton Home, a private foundation under the 1969 Act, expressing the view that such institutions are committed to long term care and need a cushion to withstand economic fluctuations and certainty for planning purposes].

[115] Certain Committee Amendments to H.R. 10612: Hearings before the Senate Comm. on Finance, 94th Cong., 2nd Sess. 465-470 (1976). Two businesses leasing adjoining properties designed for and integrated into their operations could not under the 1969 law purchase such property from foundations they had supported because they were under the self dealing rules. They asked for relief in such cases where the best use is with them, and they were willing to pay at or above fair market value.

[116] 1974 Private Foundation Hearings, 92-96.

[117] Id. at 184-185.

[118] Id. at 167 [statement of Donald Alexander, Commissioner of Internal Revenue], 1973 Tax Reform Hearings, 5789-90 [statement of Randolph Thrower, former Commissioner of Internal Revenue and counsel to Southeastern Council of Foundations].

[119] 1973 Tax Reform Hearings, 5856-58 [testimony of Waldermar A. Nielsen, consultant and author or a study on private foundations, recommending a tax credit for charitable contributions by low income taxpayers and a floor under charitable contributions by corporations]; 1974 Impact Hearings. 212, 216-218 [testimony of Marian Fremont-Smith, attorney with practice in tax exempt area, calling for elimination of differences in contribution limits, carry forward, and treatment of gifts of appreciated property when applied to foundations as opposed to public charities].

[120] 1974 Impact Hearings, 216-17.

[121] 1974 Private Foundation Hearings at 118-120, 127-135-138.

[122] Id. at 29-47 [testimony of Kyran M. McGrath, Director, American Association of Museums and 99-108 [Rollin N. Hadley on behalf of the association of Art Museum Directors]. It was suggested that there is no significant difference between the public service provided by those muse-

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dation life should be limited.[123] It was also observed that over time the corpus of such foundations had grown, and that objections to the payout requirement were based in part on consequences of short term economic events rather than the law.[124]

Tax Reform Act of 1976

Some changes were made in apparent response to these urgings in the 1976 Tax Reform Act, including change in the payout requirement, a matter addressed by nearly every foundation witness. Other issues raised in hearings in 1973 and 1974 were addressed later. Among the changes in 1976 were:

1) Modification of the minimum payout requirement to the greater of adjusted net income or 5 percent of the net value of assets, eliminating the fluctuating minimum based on 1969 money rates and investment yields;

2) Modification of the law to permit declaratory action by an organization and judicial review of an adverse determination (or failure to make a determination) by the Internal Revenue Service of the organization's exempt status;

3) Modification of the transitional rule for sales of leased property owned by private foundations to the lessee (disqualified person), if the foundation receives an amount equal to or greater than fair market value;

4) Modification of transitional rule for sale of excess business holdings to disqualified persons at price equal to or exceeding fair market value to add one year to this transition provision.[125]

Filer Commission Report

In 1975, the Commission on Private Philanthropy and Public Needs, chaired by John H. Filer, issued its report, Giving in America: Toward a stronger Voluntary Sector. This was a privately funded commission, formed in 1973 under the initiative of John D. Rockefeller 3rd and the encouragement of Wilbur D. Mills and members of the Department of Treasury. It had twin goals of studying and making recommendations about philanthropy and philanthropic institutions in the United States.

Several of its recommendations anticipated future legislation. For example, the Commission recommended increasing inducements for charitable giving by permitting all taxpayers who take the standard deduction to claim charitable contributions as an additional itemized deduction. Similar legislation, permitting a limited above-the-line charitable contribution deduction for nonitemizers, was adopted in 1981. The Commission recommended that corporations increase their giving; in 1981 the cap on corporate charitable contributions was raised from 5 to 10 percent.

The Commission recommended repealing the audit tax and replacing it with a fee based on the actual costs of auditing. In 1978

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ums classed as private foundations open to the public and those who satisfy the 10 percent public support requirement, and that museums perform educational functions and should be exempt from the private foundation class like schools and colleges.

[123] 1973 Tax Reform Hearings, 5908–09; minimum and maximum size limits were also suggested by one witness, 5852–60.

[124] Id. at 5905–08; 1974 Impact Hearings, 82–86.

[125] P. L. No. 94–455, §§ 1301, 1303, 1306, 1309; 90 Stat. 1713.

the audit tax was lowered to 2 percent. The Commission recommended a flat payout rate of 5 percent, rather than a fluctuating rate for private foundations. This recommendation was adopted in 1981. The Commission recommended allowing exempt organizations, other than private foundations, the same freedom to influence legislation as businesses and trade associations. In 1976 Congress adopted elective statutory limits on the permissible amounts which can be spent by exempt organizations to influence legislation.

Donee Group Report

In response to the Filer Commission report, the Donee Group, a coalition of public interest, social action and volunteer groups acting as advisors to the Commission on Private Philanthropy and Public Needs, put out its own undated report and recommendations. The Donee Group was formed in reaction to an article written by Pablo Eisenberg, which suggested that the Filer Commission was concerned only with the donors not with recipients of philanthropic money.[126] This group had a different perspective on the problems which ought to have been studied and the conclusions which ought to have been reached. The Donee Group criticized the Filer Commission for its desire to preserve the status quo and its excessive confidence in self-regulation.

The Donee Group recommended requiring public membership on boards of foundations; limiting donor control; publicizing information on grants, including amounts, criteria, and recipients; holding annual public meetings of the boards of charities; and eliminating expenditure responsibility.

The Donee Group recommended a number of changes in the tax laws—including extending the charitable contribution deduction to nonitemizers; encouraging additional charitable contributions, by imposing an additional 2 percent tax on corporations which could be offset by gifts of cash to charity. They also recommended abolishing the 4 percent audit tax on foundations altogether, and fixing the annual payout requirement at 6 percent of the market value of foundation assets, plus one-half of any excess income over that amount.

The Group thought that charitable organizations should take a greater role in the public decision-making process. To that end, they recommended that all limits on lobbying be removed except for a restriction prohibiting the formation of an organization strictly for the purpose of influencing legislation.

Changes in the law subsequent to 1976

With the exception of some of the amendments previously mentioned on page 38, there were few major changes in the laws relating to private foundations subsequent to 1976. Most of the other changes were minor changes intended to benefit particular groups. For example, on July 25, 1977, the Senate Finance Committee's Subcommittee on Taxation and Debt Management generally held hearings on private foundation leasing of business assets. Although

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[126] Donee Group, Private Philanthropy: Vital & Innovative: or Passive & Irrelevant? Report & Recommendations ii (Washington, D.C. undated).

the topic sounds like one of general applicability, the hearing was on a bill designed to benefit the Public Welfare Foundation, Inc., which owned the assets of three newspapers and had leased the assets to the publishers of those newspapers years before the adoption of the 1969 act. Prior to 1969, the publishers had been substantial contributors to the foundation (although not its creators). Because of these pre-1969 actions, the leasing of assets to the publishers would have been an act of self-dealing without an exemption from the self-dealing rules definition of substantial contributor. Section 3 of Public Law 95–170 provided such an exemption.

Revenue Act of 1978

In the Revenue Act of 1978, two changes were made. First, the 4 percent excise tax in IRC § 4940 was lowered to 2 percent. This change was favored by Treasury and the Filer Commission, as well as the private foundations. Second, only for purposes of the annual distribution requirements, certain long-term facilities for the care of disabled, elderly, or needy persons would be considered operating foundations, providing they spent at least two-thirds of their investment return in operating the facility. This provision was put in to benefit privately endowed organizations such as the Myron Stratton Home, providing long-term care for the indigent, children, the elderly, and the disabled. Congress believed such organizations had a need to accumulate part of their income for possible future use in view of the long-term commitment to care.[127]

1980 Laws

At the end of the 96th Congress in 1980, Congress passed three laws which amended some of the private foundation provisions. First, P.L. 96–596 cured a problem created by Tax Court interpretation of its jurisdiction over second-tier excise taxes. As interpreted by the Tax Court, these second-level taxes could never be reviewed in the Tax Court because these taxes were not imposed until after the Tax Court decision became final. Under the statute, the second-tier taxes are imposed before beginning litigation, but they are forgiven if correction is made during the correction period.[128]

Second, P.L. 96–603 consolidated into one document the annual report and the annual return which were required to be filed by private foundations.[129] Third, P.L. 96–608 contained a special provision exempting certain leases from the taxes on self-dealing. The exception covers private foundations leasing office space from a disqualified person, where the space is in a building which is also leased to other tenants who are not disqualified persons; the lease was in effect on October 9, 1969; the lease was not a prohibited transaction at the time it was executed; and the terms of the lease reflect an arm's-length transaction. This provision was designed to benefit the Moody Foundation and any other foundation which meets the specific requirements of the rules.[130]

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[127] See 1974 Impact Hearings, 78–89; Staff of the Joint Committee on Taxation, 96th Cong., 1st Sess., General Explanation of the Revenue Act of 1978 at 298–99 (Comm. Print 1979); P.L. 95–600, § 522, amending IRC § 4942.

[128] P.L. 96–596, 94 Stat. 3469, amending IRC §§ 4941–4952 and others, adding §§ 4961–4962.

[129] P.L. 96–603, 94 Stat. 3503, amending IRC §§ 6033, 6104, repealing § 5056.

[130] P.L. 96–608, § 5, 94 Stat. 3553, amending IRC § 4941(d); see S. Rep't. No. 1031, 96th Cong., 2d Sess. 14–15 (1980).

Economic Recovery Tax Act of 1981

In the Economic Recovery Tax Act of 1981, Congress made two major changes which affected private foundations. First, the minimum payout requirement was adjusted so that a foundation is not necessarily required to distribute all of its investment income. The minimum payout requirement is now 5 percent of net investment assets. If the foundation earns more income than that, it is allowed to keep the remainder. This provision was adopted to allow foundations to keep the portion of their investment return which represented compensation for the effects of inflation. If the foundations had been required to continue distributing all of their investment income, the real value of the investment assets might have been gradually eroded by inflation [131] The definition of private operating foundation was amended in conformity with this change so that a private operating foundation would now be required to spend substantially all of the lesser of its adjusted net income or the minimum investment return, in addition to meeting one of three other tests.[132] Under prior law a private operating foundation had been required to spend substantially all its adjusted net income.

The second major change dealt with charitable contributions. First, non-itemizers were allowed a limited above-the-line deduction for a percentage of their charitable contributions.[133] Second, the limit on corporate charitable contributions was increased from 5 percent to 10 percent of adjusted taxable income.[134]

Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA): Proposed Exceptions to the Excess Business Holdings Provision

During the 97th Congress a number of bills were introduced to provide exceptions to the application of the excess business holdings and divestiture requirements of IRC § 4943. For example, when the Senate Committee on Finance held hearings on October 28, 1981, on Miscellaneous Tax Bills, one of the measures being considered was S. 1745, a measure designed to exempt the El Pomar Foundation from that provision.[135]

Some sympathy was expressed for the concerns of the foundation by the subcommittee chairman,[136] and when the Senate Committee on Finance reported the bill that became TEFRA, included in its provisions were exemptions from the excess business holding requirement for El Pomar Foundation's holdings in the Broadmoor Hotel and for ownership of the Houston Chronicle Publishing Company by the Houston Endowment, Inc.[137] Other special circumstances exceptions to the excess business holdings divestiture provision were added on the Senate floor. These included: (1) an amend-

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[131] 127 Cong. Rec. S8280–S8281 (daily ed. July 23, 1981).
[132] P.L. 97–34, § 823, 95 Stat. 351, amending IRC § 4942(j).
[133] P.L. 97–34, § 121, 95 Stat. 196, adding IRC § 170(i).
[134] P.L. 97–34, § 263, 95 Stat. 264, amending IRC § 170(b)(2).
[135] 1981–82 Miscellaneous Tax Bills, XI, Hearings before the Subcomm. on Taxation and Debt Management of the Senate Comm. on Finance on S. 1035, S. 1595, and S. 1745, 97th Cong., 1st Sess., 48–54 (1981) [hereinafter cited as Hearings on S. 1745]. Because this case is illustrative of the special circumstances request for exemption, it is discussed in more detail in the section on continuing issues dealing with excess business holdings.
[136] Id. at 49.
[137] S. Rep't No. 494, 97th Cong., 2d Sess. 400–401 (1982). See S. 2506 and H.R. 6213 (97th Cong.), which were for the benefit of the Houston Endowment.

ment which exempted the Sands Springs Home (for widows and orphans) and the Otto Bremer Foundation (which owns a bank holding comany) from the excess holdings provision and provided that a certain type of trust with charitable interests (New London Day Trust) not be treated as a private foundation;[138] (2) an amendment to exempt the Public Welfare Foundation (for ownership of three local newspapers in South Carolina and Alabama);[139] (3) a five year extension of the divestiture period for the Ahmanson Foundation (for disposal of interests in a large savings and loan holding company in California).[140]

All of these special exemptions were removed by the conference committee, at the insistence of House members, and it was agreed that hearings would be held on the tax treatment of foundations, including the effect of the excess business holdings limitations.[141]

Summary of Historical Development

An examination of the history of tax treatment of private foundations suggests that the trend over the past 40 years has been to differentiate private grantmaking foundations from public charities and operating foundations for a variety of tax purposes, ranging from contribution deductions to regulation of organization and conduct. In the area of the charitable contribution deductions, differences in treatment began in 1954, when individual taxpayers were permitted to deduct charitable contributions of up to 20 percent of adjusted gross income and were given an extra 10 percent for contributions to specified charities. This evolved into present law which retains the 20 percent limit for private foundations generally, compared to a 50 percent limit for public charities and operating foundations. Additionally, while an individual can deduct the fair market value of a gift of long-term capital gain stock to public charities or operating foundations, he or she generally is entitled only to a reduced deduction if such a gift is made to a private nonoperating foundation. A major reason for this distinction appears to have been the belief that gifts to public charities and operating foundations were more rapidly utilized for public benefits, while those to foundations were often invested, resulting in delays before the gifts were used for actual charitable purposes.

Undoubtedly, the perception of foundations as a potential vehicle for tax abuse was also a contributing factor in this distinction, as it was in the development in 1969 of the definition of a private foundation and the imposition of prohibitions and limits on foundation structure and conduct enforced by an excise tax mechanism. These limitations developed from a series of studies and investigations by Congress and others, involving alleged abuses of tax exempt organizations and private foundations in particular. While there has been some liberalization of the limitations imposed in 1969, primarily at

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[138] 128 Cong. Rec. S8917-S8919 (daily ed. July 22, 1982).
[139] Id. at S8970-S8971.
[140] Id. at S9012-S9013.
[141] H. Rep't. No. 760, 97th Cong., 2d Sess. at 680-681 (1982); 128 Cong. Rec. S10943 (daily ed. Aug. 20, 1982) (statement of Senator Dole in response to a question as to the conference committee's elimination of the provision for an extension of the divestiture period for the Ahmanson Foundation).

the behest of private foundations and their beneficiaries, the major limitations remain largely intact.

The ultimate questions in any general review of the tax treatment of private foundations are what has been the effect of these provisions taken in their entirety, and whether those results are desirable or undesirable. These questions involve gathering and evaluating facts and policy judgments, which can be addressed only after a thorough investigation and can only be adjudged by the tax-writing committees and the Congress. This examination of the development and history of the tax treatment of private foundations does, however, suggest the existence of certain continuing issues, some of which are discussed in more detail in the final section of this report.

CONTINUING ISSUES

EXCESS BUSINESS HOLDINGS DIVESTITURE RULES: IRC § 4943

When Congress enacted the 1969 Act, it included provisions to limit the extent of foundation holdings in any single business. IRC § 4943 imposes excise taxes if the limitations are exceeded, but allows lengthy transitional periods for divestiture of existing holdings (see page 30 above). The reasons for the excess business holdings and divestiture provisions included: (1) a concern that private foundations were being used to maintain corporate control rather than for charitable purposes; (2) a belief that other firms in the same business might suffer competitively as a result of tax advantages of private foundations; and (3) a concern that if the charity role was emphasized, the business would suffer and vice versa.[142] Another "value" promoted by the divestiture requirement is diversification of the investment holdings of foundations which, it has been suggested, reduces the risk of loss present when tremendous portions of foundation assets are invested in a single company.[143]

Under the excess business holdings provision, the basic rule applicable to foundation ownership of a business enterprise limits a foundation and its disqualified persons to 20 percent. If a foundation acquires an excess interest in a business by gift or bequest after May 26, 1969, it has five years to reduce its interest and that of its disqualified persons to the required limit. Special provision is made for "present holdings" (holdings as of May 26, 1969). For those holdings, there are special phase down periods, varying with the proportion of the ownership (10 to 35 years) and with a higher cap than permitted for post 1969 acquisitions.

Criticism of the excess business holdings rule has been of several types. Some has come in the form of special pleas for an exemption by a particular foundation or foundations. Others have raised more general concerns about the operative effect of particular elements of the rule and made suggestions for extension of periods for divestiture or repeal of the provision in its entirety. Illustrative of the former is the testimony of the executive director of the El Pomar Foundation before the Senate Subcommittee on Taxation and Debt Management in support of S. 1745 (97th Cong.), a bill designed to exempt the El Pomar Foundation from the divestiture require-

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[142] H. Rep't. No. 413, 91st Cong., 1st Sess. 27–31 (1969); Staff of the Jt. Comm. on Taxation, 91st Cong., 2nd Sess. General Explanation of the Tax Reform Act of 1969 91st Cong., 2nd Sess. (Comm. Print 1970).

[143] General Tax Reform: Hearings before the House Comm. on Ways and Means, Part 17, 93rd Cong., 1st Sess. (1973) (testimony of Rep. Patman at 6776, 6790–91, noting that the Hartford Foundation had 84 percent of its assets in A&P stock, which had fallen tremendously in value and discontinued its dividend). Of course, a stock might also do better than a diversified portfolio, but the risk is reduced by diversification. The opposite was true for the Kellogg Foundation, "1973 Tax Reform Hearings" 5873.

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ments of the excess business holdings provision imposed in the 1969 law.[144]

The El Pomar Foundation owns the Broadmoor Hotel, a resort hotel, and related improvements including three eighteen-hole golf courses, a ski area, arena, and some 2,000 surrounding acres. It was argued that the divestiture provision was intended to eliminate donor control, that the founder had died in 1939, his wife in 1956, and for 25 years no substantial contributor or relative had been associated with foundation management. Thus, it was suggested no purpose would be served by requiring divestiture in this case.

Secondly, the foundation representative argued that in the case of the Broadmoor resort property, that property and the interests of the community of which it was a part would be best served if it was kept in local hands; the foundation has hired professional management for the hotel, and thus foundation managers were not devoting their efforts to running the resort; the foundation was and is successful, having given grants exceeding its original corpus fourfold; and the Broadmoor properties are worth much more than when given. If forced to sell there would be few prospective buyers, probably conglomerates or hotel chains, and those, knowing the sale is required, would take advantage of the circumstances to get a bargain purchase. Such absentee owners might be less responsive to the community.

Treasury has opposed attempts to exempt particular foundations from excess business holding divestiture requirements, maintaining that even if there is no donor/donor-family management of the foundation, the provision was intended to serve other purposes, including avoiding foundation management concentration on business growth and development at the expense of charitable concerns. It has also argued that a charitably owned business may enjoy a competitive advantage over other similar businesses as a result of tax treatment, and that an exemption of a particular foundation would be unfair to those other foundations similarly situated which have made efforts to divest themselves of excess business holdings in compliance with the law.[145]

Others have suggested more general problems with the excess business holdings provision. The most frequently expressed concerns revolve around the limitations applicable to post 1969 acquisitions. It has been argued that the 20 percent of ownership limit, the five year divestiture provision, and the self-dealing limits on sale of excess business interests combine to discourage creation of new foundations and gifts of control stock to existing foundations, such business interests being a major source of foundation funding in the past. Potential buyers, it is said, are aware of the short time frame for divestiture and may prolong negotiations, creating a forced sale situation, so that to comply with the law the foundation will sell for less than a reasonable price. Potential contributors are discouraged because they may face forced sales and loss of value for retained holdings. It has been urged that the five year divestiture period be extended to 10 or 15 years and that provisions limit-

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[144] Hearings on S. 1745 at 48–54.

[145] Id. at 23–26, testimony of Assistant Secretary (Tax Policy) of the Treasury, John E. Chapoton.

ing purchases by disqualified persons be relaxed, since these persons may have the greatest interest in such a purchase and be willing to pay top dollar.[146]

Some supporters of modifying post 1969 acquisition of excess business holdings rules (to give more time for divestiture or relax limits on purchases by disqualified persons) have indicated acceptance of the provisions for "present holdings" with their extended periods for compliance.[147] Others insist that divestiture is unnecessary and even harmful to some foundations, citing instances where foundation-owned stock in a single business entity had performed exceptionally well compared to composites (e.g., mutual funds) in support of the latter argument. It is said that some reasons for the inclusion of the excess business holding provision involve erroneous assumptions or that particular concerns are met by other provisions of the act, including the minimum payout requirement, which meets the objection that foundations are really tax shelters, making little money for and spending little money on public purposes.[148]

There are three basic options in terms of general policy: (1) leave present law unchanged; (2) extend the period of divestiture of post-1969 acquisitions by gift or bequest of excess business interests beyond the five years allowed by present law; (3) eliminate the excess business holdings provision in its entirety. Another policy option is to provide exemptions from the rule in "unusual" cases, either by narrowly drawn exemptions or extensions tailored to individual situations or by giving Treasury authority to grant exemptions or extensions when identifiable conditions Congress believes warrant such treatment are satisfied.

Assuming that the original reasons for the adoption of the excess business holding provision were and are valid, no change in the law which would exempt particular foundations from its operation can be easily reconciled with those purposes. It may be true that the stock (excess business holdings) which a particular foundation holds has out-performed a typical diversified portfolio, but this would not be true of every such investment, and diversity might bring greater security to foundation asset values generally. In any event, the potential problem of emphasizing business at the expense of charitable interests or vice versa would be present with any exemption. Even some from the foundation community have accepted the provision as basically reasonable, though urging a longer transition period for interests recently acquired by gift or bequest and liberalization of provisions involving transactions with disqualified persons.[149]

Individual foundations may make a strong argument that because of special circumstances they should be exempt; but it can be maintained in opposition to any such request that it would open

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[146] Chairman and Staff, Council on Foundations, Inc., "Private Foundations and the 1969 Tax Reform Act," in Research Papers Sponsored by the Commission on Private Philanthropy and Public Needs, Dep't. of the Treasury 1557, 1576, 1596 (1977) [hereinafter cited as "Private Foundations and the 1976 Tax Reform Act"]. "Legal Impediments to Effective Foundations Philanthropy," statement submitted by The Council on Foundations to the Committee on Impediments, Presidential Task Force on Private Sector Initiatives (February 10, 1982).

[147] Id.

[148] Hearings on S. 1745, 58-61 and 66-73.

[149] "Private Foundations and the 1976 Tax Reform Act" 1596.

the door to a flood of special pleas, that others have complied since 1969 and fairness requires uniform treatment, and that, as noted above, any exemption is difficult to reconcile with some of the purposes served by the original enactment, assuming those are still valid. If certain common characteristics can be found in individual foundations believed deserving of exemption, a statutory standard for administratively granting exemptions in "special circumstances" might be framed. It may, however, be hard to identify such characteristics and draft a provision narrow enough to avoid undermining the limitation in its entirety, and the basic objection to any exemption remains.

On the other hand, extensions might be easier to reconcile with the original purposes of this provision. The prohibition would remain although the time for compliance would be lengthened. In the case of "present holdings" the time periods were fairly generous (10 to 35 years); but it is at least arguable that for new acquisitions, the 5 year period is too short to permit an orderly liquidation of excess interests at a fair price. If the evidence indicates that this provision is a hindrance to the flow of assets to foundations and that, as a matter of policy, it is desirable to modify the provision to encourage an increase in gifts/bequests to foundations, an extension from 5 to 10 years might be easier to justify in terms of existing policy than a longer extension. This would equal the shortest period applicable to "present holdings" under the 1969 law and double the present time frame.

One option which has been introduced to modify the 5 year rule applicable to new acquisitions is H.R. 2032 (98th Cong.). It would authorize extensions of the 5 year period by the Secretary of the Treasury upon written request of the foundation and after consideration of the facts and circumstances. The factors to be considered include: whether there has been a good faith effort during the initial period to comply with the provision for divestiture; whether an orderly disposition can be accomplished during an extension; the size of the holding compared to others in that trade or business; whether there would be adverse economic consequences caused by forced disposition; the pendency of lawsuits or other legal impediments to an orderly disposition; the recommendation of the attorney general of the State of incorporation; and other relevant facts and circumstances. One or more extensions of a minimum of 24 months may be granted. There is no maximum limit to the length or number of extensions, and without such a cap, it is possible such extensions could continue indefinitely, beyond the limits for "present holdings" under the 1969 Act (10 to 35 years).

If it is believed that the 5 year rule provides inadequate time for an orderly divestiture in some situations, the approach of H.R. 2032 in granting administrative discretion to extend the period is arguably preferable to a blanket extension, since presumably extension would have to be justified, and where there is no reason for not complying with the five year rule, no extension would be given. Objections to the absence of a cap and the potential for more favorable treatment for new acquisitions subject to the 5 year rule than old assets, which may have been given long before the limit was imposed and thus without the notice provided by the law itself, could be met by modifying the proposal to limit extensions to 5

years in total. Treasury, in its comments on a similar Senate bill (S. 562, 98th Cong.), has objected to the breadth of discretion which would be granted and suggested a single 5 year extension based on more narrowly drawn standards. The suggested criteria include (1) a diligent effort to comply in the first 5 year period and (2) inability to do so except at a price substantially below current fair market value, because of specified factors, (3) submission of a realistic plan for disposal during the extension, and (4) agreement of each state attorney general with administrative or supervisory authority.[150]

The preceding analysis has been predicated in large measure on acceptance of the assumptions and purpose of the original enactment. Even if those assumptions and purposes remain valid, other, competing considerations may be considered sufficient to overcome them in some cases. For example, special circumstances may be found to be so compelling in a particular case that counter arguments are viewed as insufficient to reject a narrowly drawn exemption. This was apparently the judgment of the Senate in 1982 when it included, as noted above, such exemptions in its version of TEFRA.

Contribution Limitations: IRC § 170

Different contribution limitations apply to gifts made to private foundations generally than to gifts to public charities or operating foundations. An individual contributor may deduct up to 50 percent of adjusted gross income for cash contributions to public charities, private operating foundations, and certain private nonoperating foundations which either (1) distribute all contributions received to public charities or operating foundations within 2½ months following the year of receipt or (2) pool their contributions into a common fund paying the income and principal sum to public charities.[151] For contributions to private nonoperating foundations generally the deduction limit is 20 percent of adjusted gross income.[152]

As indicated in the statutory and legislative history summarized above, deduction limits on charitable contributions have been part of the tax law since 1917. Differences in the percentage limits, varying with the nature of the recipients, began with the 1954 Code, which provided a 20 percent limit plus an additional 10 percent for contributions to religious or educational institutions or certain types of hospitals. While over time the institutions qualifying a contributor for the increased cap have expanded and the cap has been raised to 50 percent for cash contributions, the 20 percent limit has been retained for gifts to most private non-operating foundations.

Other differences which have emerged in the post-1954 period include providing a five-year carryover for gifts in excess of the cap applicable where the 50 percent rule applies but none to private

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[150] Statement of Jackie S. Levinson, Deputy Tax Legislative Counsel, Department of the Treasury, before the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance (June 7, 1983).

[151] IRC § 170(b)(1)(D) (ii) (iii), § 170(b)(1)(A)(vii).

[152] IRC §170(b)(1)(B).

foundations where the cap is 20 percent.[153] Additionally, a donor of long term capital gain property may deduct the fair market value of such a gift if made to a public charity or operating foundation, but the deduction must be reduced by 40 percent of the amount of long term capital gain when the gift is made to a private foundation where the 20 percent cap applies.[154]

Among the various issues which might arise in an examination of contribution limits are whether such caps serve any useful function, whether there is any reason for less favorable treatment of contributors to private foundations, and if so, whether some changes should be made though differences are retained.

Some understanding of the rationale for imposing a percentage limit on deductions for charitable contributions can be gleaned from the 1969 repeal of a provision permitting an unlimited deduction for individuals whose gifts (excluding gifts to private foundations generally) plus taxes exceeded 90 percent of their taxable income during the tax year and the preceding 8 years. The reason for repeal was explained in the report of the Committee on Ways and Means, which noted that its examination indicated that the charitable contribution deduction was then the most important deduction for high-income individuals paying little or no tax. "Your committee does not believe that high-income taxpayers should be allowed to minimize or avoid tax liability by means of the charitable contribution deduction. Accordingly, your committee believes the unlimited charitable deduction should be repealed. The effect of this, in combination with the increase in the general limitation on the deduction to 50 percent, is that charity can remain an equal partner with respect to an individual's income, but charitable contributions no longer will be allowed to reduce an individual's tax base by more than one-half.[155]

The question remains as to the why Congress has in its enactments over the last 30 years treated private nonoperating foundations less favorably than public charities and operating foundations. One reason was given by the Senate Finance Committee in its report on the Revenue Act of 1964 and the expansion of the category of organizations to which donations were eligible for the additional 10 percent (30 percent) deductions limit:

> The additional 10-percent deduction is limited to organizations which are publicly or governmentally supported, however, and this additional deduction is not made available in the case of private foundations. These latter types of organizations frequently do not make contributions to the operating philanthropic organizations for extended periods of time and in the meanwhile use the funds for investments. The extra 10-percent deduction is intended to encourage immediately spendable receipts of contributions for charitable organizations.[156]

In brief, greater benefits are considered justified where the donation is more immediately and directly used for charitable purposes. That reasoning is reflected in the provision applying to contributions to certain types of private foundations, where the donations are more immediately or directly used, the more liberal contribution deduction rules applicable to gifts to public charities. Thus, for

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[153] IRC § 170(d).
[154] IRC § 170(e)(1)(B)(ii).
[155] H. Rep't. No. 413, 91st Cong., 1st Sess. 52 (1969).
[156] S. Rep't. No. 830, 88th Cong., 2nd Sess. 58 (1964).

example, operating foundations, which make expenditures directly for tax exempt purposes, and conduit foundations, which make qualifying distributions equal to 100 percent of all contributions received (cash or property) during the year by the 15th day of the 3rd month after the close of its tax year, qualify for the more generous limits.[157]

A second reason for the distinction appears to have been concern over the potential for tax abuse through the private foundation mechanism. When the Tax Reform Act of 1969 was adopted, it included limits and prohibitions aimed at preventing such abuses. The Act also included new provisions governing charitable contributions of appreciated property, including a provision requiring reductions from fair market value of capital gain property given to private foundations, except (1) operating foundations or (2) where the foundation serves as a conduit.[158] In this context, concern for potential abuse and a desire to encourage more immediate realization of the public benefits justifying deductions and tax exempt status seemed to have been motivating factors in the distinctions.

A third reason, suggested by the history of the law and the excerpt from the Senate report quoted above, was the degree of public involvement. In seeking public support the public charity provides information as to its activities, and its success in attracting public contributions may, to some extent, be a measure of public awareness and approval of its activities. The private foundation, in contrast, was viewed as less subject to public scrutiny and approval, since it is generally created, funded, and operated by a small group of individuals.

Congress has been urged to eliminate these differences between private foundations and other charitable organizations, and legislation to that effect has been introduced in the 98th Congress (H.R. 1387 and H.R. 3043). It has been said that the limits imposed on deductions for contributions to private nonoperating foundations inhibit the growth and development of foundations and thus their contribution to charity; that other changes in the law address the concerns which generated these distinctions, including the minimum payout requirement, accountability provisions, and other limits imposed in 1969; and that changes in the tax rates reduce the tax benefit of such contributions.[159]

It may be desirable to examine proposals to equalize the tax treatment of deductions to private foundations and public charities, and the arguments advanced in support of such a change, in the context of the history of the development of present law. If differences in public participation and benefit are found which it is believed justify differences in tax treatment but not differences of the magnitude in present law, a compromise between retention of the present law and total elimination of differences might be desired. For example, consideration might be given to raising the cap to 30 percent, equal to the present cap on gifts of appreciated property to charities, and permitting a deduction for fair market value of gifts

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[157] IRC § 170(b)(1)(A)(vii); § 170(b)(1)(D) (50 percent cap); § 170(e)(1)(B) (exempt from capital gain reduction); § 170(d) (carryover).

[158] IRC § 170(e)(1)(B); § 170(b)(1)(D).

[159] 129 Cong. Rec. E2339-E2441 (daily ed. May 18, 1983); "Legal Impediments to Effective Foundation Philanthropy", 10-12.

of long term capital gain property to private foundations. Alternatively, such differences may be found to be insufficient in light of other provisions limiting private foundations, to justify any differentiation in contribution deduction limits, or it may be concluded that the differences continue and are significant enough to warrant continuation of the distinctions in present law.

Expenditure Responsibility for Small Grants: IRC § 4945(d)

The expenditure responsibility requirements were enacted in 1969 as part of an effort to make private foundations accountable for the use of their funds. The expenditure responsibility provision requires foundations to know that their grantees will spend the money for charitable purposes.

The expenditure responsibility provisions require foundations to exert all reasonable efforts and establish adequate procedures to see that the grant is spent only for the purpose it was made, to obtain reports on how the funds were spent, and to make full and detailed reports to the IRS. These procedures are required for any grants made to an organization which is not a public charity. Under Treasury regulations these requirements necessitate making a pre-grant investigation of the grantee, entering into a written grant agreement, obtaining accountings from the grantee, and filing annual reports with the IRS.

The expenditure responsibility provision has been criticized as being unduly burdensome, especially for small foundations which lack administrative capacity to fulfill these requirements.[160] It is said that it is easier for large foundations to supervise a few large grants rather than to orchestrate the paperwork on a number of small grants. Expenditure responsibility is said to encourage routine, status quo grants. Foundations may steer clear of grants to foundations, if the grants might have legal, accounting or investment difficulties. Rather than evaluating a grant in terms of the needs it fulfills or its feasibility, the donor foundation may prefer to make grants that will not generate undue administrative or supervisory problems. This may mean that small-scale charitable projects cannot attract the funds they need to survive.[161]

Several bills in the 97th and 98th Congresses have proposed providing a *de minimis* exception to the expenditure responsibility requirements for grants of amounts of up to $10,000 or $15,000. Under these proposals, foundations would not have to exercise expenditure responsibility over grants to a private foundation if all the donor foundation's grants, along with those of any related foundations made to the same donee, did not exceed a certain amount per year.

It is suggested that—

This amendment will not in any way affect the explicit statutory requirement that every foundation grant, large or small, go to support a recognized charitable activity. Nor will it affect strict IRS requirements that foundations making grants to non-exempt grantees make every reasonable effort, including requiring periodic

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[160] Remarks of Barber B. Conable, Jr., 128 Cong. Rec. E2340 (daily ed. May 18, 1983); Private Foundations: Hearings before the Subcom. on Foundations of the Senate Comm. on Finance, 93d Cong., 2d Sess. 95 (1974) [remarks of Joe G. Dempsey, Executive Director of the Los Angeles Inter-Foundations Center]; "Legal Impediments to Effective Foundation Philanthropy" 16–17.

[161] "Legal Impediments to Effective Foundation Philanthropy" at 16–17.

reports from grantees, to ensure that every grant dollar is spent for the designated charitable purpose. Instead, this amendment merely recognizes that the specialized, highly detailed, and formalized expenditure responsibility requirements which may be appropriate for large grants are counterproductive when applied to small grants.[162]

Treasury opposed a similar provision in Senate hearings held in 1981 on a similar bill. Assistant Secretary John E. Chapoton testified that—

Expenditure responsibility was imposed upon private foundations as part of an overall statutory framework enacted in 1969 to make private foundations publicly accountable for the funds they apply to charitable purposes. Expenditure responsibility helps ensure that foundations will make grants for charitable purposes and that grantees will carry out the terms of these grants. We do not believe that this statutory scheme should be dismantled piecemeal.

We would be happy to consider suggestions for administratively streamlining the procedures involved with expenditure responsibility if a showing could be made that the present rules are unduly burdensome. However, the Congressional intent in making foundations publicly accountable for their grants is still of concern, and is valid for all grants, regardless of their size. A threshold dollar amount for grants that may be made without regard to expenditure responsibility is an arbitrary distinction that is unrelated to the purpose of the statute.[163]

An initial question relates to the value of a uniform policy on expenditure responsibility for all grants of any size. In part, the resolution of this issue involves a weighing of the administrative burden of the present law against the possibility of abuse of unsupervised grants. However, in addition to preventing donees from squandering the funds, another benefit of the expenditure responsibility rules may be the involvement of the donor in the donee's program. In order to exercise its expenditure responsibility, the donor may be forced to share its legal, financial, and management expertise with a small, innovative, not yet expert donee organization. This may improve the overall use of foundation funds.

Bills requiring the unsupervised grants to be made to a 501(c)(3) organization might minimize cases of abuse, since the IRS is charged with overseeing the activities of any 501(c)(3) organization. However, the problem with arguing that making a grant to a charitable organization will minimize the possibility of abuse and mitigate the need for expenditure responsibility in the case of small grants is that if this is true, the same argument could be used to justify relieving foundations of expenditure responsibility any time a grant is made to a charitable organization, regardless of the size of the grant. A precedent would be created so that the *de minimis* exceptions might continue to grow. Such a change would shift the responsibility of grant supervision to the IRS from the grantmaking private foundation. It is unlikely that the IRS has the staff to do as thorough a job as the statute requires of the foundations.

Another question which must be raised is whether an exemption of small grants from the expenditure responsibility requirements might not cause foundations to prefer small grants to large grants which would have to be supervised. This might lead to a situation where large and ambitious programs would not be funded because of the expenditure requirements.

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[162] Remarks of Barber B. Conable, Jr., 128 Cong. Rec. E2340 (daily ed. May 18, 1983).

[163] 1981-82 Miscellaneous Tax Bill III: Hearings before the Subcom. on Taxation and Debt Management of the Senate Comm. on Finance 51 (1981).

If it is believed that the expenditure responsibility requirements are unduly burdensome for small grants to foundations, and that the flow of small grants is being stifled by these requirements, there are two approaches which might be considered as an alternative to a blanket *de minimis* rule. The first is the alternative suggested by the Treasury–exploring with the IRS possible ways that expenditure responsibility requirements might be streamlined for small grants and seeing that these changes are implemented. The second is developing some sort of statutory standard for small-grants to organizations analogous to the rules in IRC § 4945(g) which apply to grants to individuals, requiring preclearance of the procedures for making the grants but not requiring extensive supervision of the grant once it is made.

First Tier Excise Taxes: IRC §§ 4941–4945

Current law provides a two-tier excise tax sanction mechanism to ensure compliance with the private foundation rules. Any violation of the rules triggers an automatic first level excise tax ranging from 5 percent to 15 percent of the amount involved in the transaction. Unless the violation is corrected within the statutory correction period, a far more substantial second level tax, ranging from 100 percent to 200 percent of the amount involved, is imposed. In the case of repeated violations of the rules, private foundation status may be terminated.

Because of the complexity of some of the private foundation rules and because smaller foundations may not have sophisticated legal counsel, inadvertent violations of these rules may occur. An additional problem is that four of the five penalty taxes provide that when a violation has occurred, the first level tax is reimposed annually until the violation is corrected or until the foundation is audited and notified of its liability for the penalty tax. As a result, the amount of the first level tax depends on the time elapsed between the time of the violation and the audit of the foundation's return by the Service. In addition, because first level tax continues to build while taxpayers seek administrative review of the tax liability, current law encourages taxpayers to bypass the administrative review process in favor of judicial action.[164]

It has been suggested that since these taxes are not intended to raise revenues, no purpose is served by imposing the tax in cases of inadvertent violations and by annual reimposition of the tax until review of the foundation's return is completed. At least three bills introduced in the 97th and 98th Congress would require the Secretary of Treasury to abate or refund any first-tier tax if the Secretary determines that the taxable event was due to reasonable cause, and not to intentional disregard of rules and regulations, and the event was corrected within the correction period (H.R. 1387 (97th Cong.); H.R. 874 and H.R. 3043 (98th Cong.)).

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[164] "Legal Impediments to Effective Foundation Philanthropy" at 14–15. The excise tax on taxable expenditures described in IRC § 4945 does not accumulate annually. (This is the tax imposed for failure to exercise expenditure responsibility or for making political or lobbying expenditures.) It should also be noted that the tax on self-dealing is imposed on the self-dealer, not on the foundation (IRC § 4941).

These bills are not unlike the discretion granted to IRS to waive the penalty for failure to timely file a return or pay a tax due where the failure is due to reasonable cause (e.g. IRC § 6651). This language would essentially relieve private foundations or self-dealers that do not intentionally violate the prohibitions of IRC §§ 4941–4945 from the first tier excise taxes.

Questions which might be considered include whether there is an *in terrorem* or other purpose served by imposing the taxes on every taxable event; whether only certain of the prohibitions provide traps for the unwary or ill-advised so that the provision could be limited to these situations; whether the unfairness results from the annual reimposition of the tax rather than the initial tax itself and thus IRS discretion could be limited to the additions to the tax rather than the basic tax itself; and whether the waiver ought to be limited to situations involving foundation discovery and confession of the violation, rather than violations uncovered on audit.

Other Issues

The discussion of issues has to this point concentrated on those questions which, on the basis of recent history and proposed legislation, appear likely to be raised most frequently in any current hearing on the subject. Other areas of possible concern include:

1. Public accessibility.—Questions may be raised as to whether foundations are doing enough to make information available to the public and potential grant seekers as to foundation resources; grants, their availability and grant making procedures; foundation operations; and whether a statutory mechanism can and should be devised to broaden public access to foundation resources and participation in foundation affairs, perhaps by providing for some form of public membership on foundation boards.[165]

2. Excise tax on net investment income.—Questions are likely to be raised as to the necessity of the present 2 percent tax, because it raises more money than is required for IRS supervision of all exempt organizations. Foundation representatives will probably urge its reduction, arguing that this money could otherwise be used for their charitable operations.[166] An alternative might be to encourage the IRS to spend additional resources on supervision, studies, gathering and dispensing information, and related activities involving foundations and other exempt organizations.[167]

3. Expenditure responsibility; reliance on IRS determination of tax status of donee.—Present law requires a foundation to exercise expenditure responsibility over grants it makes unless they are made to public charities. It was enacted because Congress believed that private foundations should take "substantial responsibility for the proper use of the funds they give away."[168] In some cases the grant from a private foundation to a donee may alter the latter's tax status so that expenditure responsibility is required. It has been urged by some that a foundation should be permitted to rely,

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[165] Donee Group, supra n. 125 at 19–23.

[166] "Legal Impediments to Effective Foundation Philanthropy" at 10.

[167] 1974 Private Foundation Hearings at 49–61 [testimony of Patricia Singer, Public Citizen Tax Reform Research Group].

[168] Joint Committee on Internal Revenue Taxation, 91st Cong., 2nd Sess. General Explanation of the Tax Reform Act of 1969 48 (Comm. Print 1970).

absent actual knowledge to the contrary, on published IRS rulings rather than being forced to expend its time and resources verifying the status of a prospective grantee and the effect of its grant on that status and donor's responsibilities.[169]

4. Definition of family member.—Under present law many restrictions are placed on the relationship between the foundation and "disqualified persons", including family members, lineal descendants of substantial donors and their spouses. Questions have been raised about the necessity of imposing such indefinite limits, and it is argued that after several generations there may be a substantial burden in keeping track of hundreds of descendants.

Proposals have been made to limit the definition of family members to children, grandchildren and their spouses.[170] Treasury has indicated it opposes these proposals; maintains that foundations keep such records anyway and that this is an important element in preventing abuses that the 1969 Act was designed to prevent; but has indicated that there may be cases where records are a burden because of numbers and suggested an (unspecified) narrower approach.[171]

5. Public support requirement.—In order to be a public charity, some organizations must rely on IRC § 170(b)(1)(A)(vi), which describes "an organization * * * which normally receives a substantial part of its support * * * from a governmental unit * * * or from direct or indirect contributions from the general public." Treasury regulations require these organizations to show that they generally receive at least 10 percent of their annual support from the public and that other facts and circumstances indicate substantial public support and involvement.[172]

Some foundations feel that they should be entitled to public charity status even though they cannot meet the 10 percent of public support test. Among these groups are community foundations, art museums, libraries, and orphanages. They argue that they are as entitled to public charity status as churches, schools and hospitals, and that they should not be penalized for having large endowment incomes.[173]

Proposals have been made to add to the types of groups which may automatically qualify as public charities and to ask IRS to modify its regulation.[174]

6. Payout requirement.—The payout requirement and related minimum investment return have been repeatedly criticized by foundations and their beneficiaries, as requiring an invasion of assets. As we have seen, these provisions have twice been modified in response to such criticism. Originally, the payout requirement was the higher of the minimum investment return or net investment income. The minimum return rate was 6 percent of assets of

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[169] 129 Cong. Rec. E2340 (daily ed. May 18, 1983); considerations involving a proposal to except small grants from this requirement, supra, are generally applicable in this case also; see H.R. 3043 (98th Cong.).

[170] 129 Cong. Rec. (daily ed. May 18, 1983) E2340; See H.R. 3043 (98th Cong.).

[171] 1981–82 Miscellaneous Tax Bills III, Hearing before the Subcomm. on Taxation and Debt Management of the Senate Comm. on Finance on S. 388, etc., 97th Cong., 1st Sess., 52–53.

[172] Treas. Reg. § 1.170A–9(e)(3)(i).

[173] 1974 Private Foundation Hearings at 19–47 [statement of Kyran M. McGrath, Director, American Association of Museums]; "Legal Impediments to Effective Foundation Philanthropy" at 4–5.

[174] Id.

1970 and adjusted by Treasury to reflect changes in money rates and investment yields. Now the payout is simply 5 percent of assets. In 1969, as previously noted, the Petersen Commission suggested a payout rate of 6 to 8 percent. It may be said by some that a properly managed foundation should be able to earn and payout at a rate higher than 5 percent.

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